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Companion to PPC's Guide to

Audits of Nonpublic Companies

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Interactive Self-study CPE

Companion to PPC's Guide to Audits of Nonpublic Companies

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INTRODUCTION

Companion to PPC's Guide to Audits of Nonpublic Companies consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Audits of Nonpublic Companies* designed by our editors to enhance your understanding of the latest issues in the field. *PPC's Guide to Audits of Nonpublic Companies* and other PPC products are available for purchase at **tax.tr.com**/**ppcguidance**.

To obtain credit for this course, you must complete the learning process by logging on to our Online Grading System at **cl.tr.com**/**ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **March 31, 2019**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

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Each course is divided into lessons. Each lesson addresses an aspect of nonpublic company audits. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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end of the course PDFs. They may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Payment for emailed or faxed answer sheets is $95. There is an additional $10 charge for manual print grading, so please include a total of $105 with answer sheets sent by regular mail. Please take a few minutes to complete the **Self-study Course Evaluation** so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($95 when sent by email or fax; $105 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S GUIDE TO AUDITS OF NONPUBLIC COMPANIES

COURSE 1

CASH BALANCES, PROPERTY, OTHER ASSETS, AND LIABILITIES AND EQUITY (ASBTG181)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses auditing specific components of the balance sheet. Lesson 1 discusses the audit of cash balances. Lesson 2 covers the property component of the balance sheet. Lesson 3 covers the audit procedures for various common categories of other assets. Lesson 4 discusses the audit of liability and equity accounts.

PUBLICATION/REVISION DATE: March 2018

RECOMMENDED FOR: Users of *PPC's Guide to Audits of Nonpublic Companies*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **March 31, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Cash Balances

Completion of this lesson will enable you to:

- Identify audit evidence procedures and workpaper considerations specific to the cash component of the balance sheet.
- Recognize problems common to auditing cash balances, including overauditing, underauditing, and fraud risk.

Lesson 2—Property

Completion of this lesson will enable you to:

- Identify audit evidence procedures and workpaper considerations that are appropriate for auditing property and describe problems with auditing property, including overauditing, underauditing, and fraud risk.

Lesson 3—Other Assets

Completion of this lesson will enable you to:

- Determine how to implement procedures to obtain audit evidence related to other assets.

- Identify workpaper considerations for auditing other assets, as well as commonly occurring problems, such as overauditing, underauditing, and fraud risk.

Lesson 4—Liabilities and Equity

Completion of this lesson will enable you to:
- Identify procedures that can be used to obtain audit evidence relevant to liability and equity accounts.
- Recognize how to audit liability and equity accounts by addressing workpaper considerations and commonly occurring problems, such as overauditing, underauditing, and fraud risk.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com**/**ogs.** Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
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ASBTG181 Self-study CPE
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See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Cash Balances

INTRODUCTION

Typically, cash represents an insignificant portion of total assets; however, a relatively large share of the total audit effort is often spent on this component of the balance sheet. Many of the cash audit procedures that have evolved as "customary in all audits" are designed primarily for the detection of fraud. Also, since cash is relatively easy to substantiate, there is a tendency to extend procedures to an extreme simply because it is feasible. This lesson explains why audit procedures designed to obtain a precise accounting for cash are neither necessary nor desirable in many cases.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify audit evidence procedures and workpaper considerations specific to the cash component of the balance sheet.
- Recognize problems common to auditing cash balances, including overauditing, underauditing, and fraud risk.

Accounting Standards

Since cash presents few valuation problems, Generally Accepted Accounting Principles (GAAP) for cash are more concerned with disclosure than measurement. The primary disclosure matters that the auditor considers when designing the audit program are:

a. Amounts that do not meet the definition of cash in FASB ASC 230-10 must be classified as cash equivalents or as other short-term investments. Generally, only highly liquid investments with original maturities of three months or less qualify as cash equivalents. A company's policy concerning which short-term, highly liquid investments are considered cash equivalents should be consistently followed.

b. Significant amounts of cash and cash equivalents that are not readily available for normal disbursements because of withdrawal restrictions or other restrictions imposed by contract, law, or regulation should be appropriately disclosed, and consideration should be given to the classification of those amounts as noncurrent assets.

c. Normally, material bank overdrafts are presented as a separate caption among current liabilities. Similarly, material dollar amounts of checks dated at or before the balance sheet date (and reflected as outstanding checks on the bank reconciliation) that were not released until after the balance sheet date should be reclassified as accounts payable. (These are commonly referred to as "held checks.")

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

According to AU-C 500.06, *Audit Evidence*, appropriate audit procedures should be designed and performed to obtain sufficient appropriate audit evidence. AU-C 500.A10 states that those audit procedures consist of risk assessment procedures, tests of controls, and substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor's opinion but do not, by themselves, provide sufficient appropriate audit evidence. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, at AU-C 330.18, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The auditor uses relevant assertions in

assessing the risks of material misstatements by considering the different types of potential misstatement that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

Relevant Assertions for Cash

The relevant assertions for cash are as follows:

- Existence or occurrence (E/O)—Cash reflected in the financial statements exists, and cash transactions occurred and pertain to the entity.
- Completeness (C)—All cash transactions have been recorded. Cash balances reflect all cash and cash items on hand, in transit, or on deposit with third parties. Related disclosures are complete.
- Rights or obligations (R/O)—Cash is owned by the entity, and any restrictions on the availability of funds are identified and properly disclosed.
- Cutoff (CO)—Cash balances reflect a proper cutoff of receipts and disbursements.
- Accuracy or classification (A/CL)—Cash transactions have been properly recorded as to account and amount. Cash balances are properly classified in the balance sheet, and the information about cash required by GAAP is disclosed fairly at appropriate amounts.

Valuation is ordinarily not relevant to cash accounts unless currency translation is involved.

Substantive Audit Procedures for Cash

In general, the substantive audit procedures for cash primarily focus on obtaining assurance about the reliability of the entity's bank reconciliation, which provides audit evidence about existence or occurrence, completeness, accuracy or classification, and cutoff. Auditors often confirm the balance of selected cash accounts as the primary test of the existence assertion as well as to obtain evidence about rights or obligations. However, if the client has one or two primary accounts and numerous secondary accounts that have minimal activity or risk, confirmations might only be requested for the primary accounts. For the accounts not confirmed, the bank balance shown on the bank reconciliation can simply be agreed to the bank statement. (Cash confirmations are not required by GAAS. Depending on the combined assessed level of inherent and control risk over the existence of cash, the auditor might limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.

Other substantive audit procedures for cash generally consist of analytical procedures, such as scanning bank reconciliations for reasonableness and scanning cash receipts and disbursements for significant or unusual transactions near year end, which provide assurance about existence or occurrence, rights or obligations, completeness, and cutoff. Other than scanning, there are no particular substantive analytical procedures that are generally useful for cash. Balance-sheet account balances that can be materially affected by relatively minor differences in the timing of transactions are not predictable enough at the balance-sheet date to be adequately tested using analytical procedures. Cash is an outstanding example because small differences in the timing of cash receipts or disbursements and in cash management policies and practices can significantly change the ending balance.

Vouching and tracing may not be necessary on all bank account reconciliations, but there is a tendency to perform these procedures automatically. For example, some auditors have routinely applied tracing and vouching procedures to every bank account reconciliation even though the activity (and level of risk) in certain accounts did not warrant those additional procedures. Generally, tracing and vouching are necessary only for cash accounts with a higher assessed risk of material misstatement and for validation of significant unusual reconciling items. In the electronic banking environment, cancelled checks and other documentation are not usually returned with a bank statement. The auditor may need to test controls and tailor the tracing and vouching procedures to the circumstances. The client's bank typically provides online electronic banking services, which include images of cancelled checks that the auditor may use as evidence when performing tracing and vouching procedures.

In addition to reviewing confirmations received from financial institutions, auditors might also review loan and debt agreements and corporate minutes and make inquiries of management to obtain audit evidence about the following matters, which relate to assertions about presentation and disclosure (for example, the accuracy of disclosures and appropriate classification):

- Guarantees, endorsements, and/or letters of credit, including guarantee arrangements for related parties.
- Amounts designated for special purposes.
- Amounts that are restricted in any manner, including withdrawal restrictions and minimum balance requirements.
- Whether amounts are appropriately classified as cash, cash equivalents, or other short-term investments.

Auditors generally coordinate those procedures with debt and contingency procedures in other audit program areas, including steps in the general program. Assurance about the completeness of disclosures is ordinarily obtained by filling out a disclosure checklist, as part of general auditing and completion procedures.

If the client has numerous interbank transfers and the auditor has assessed a higher risk of material misstatement associated with cutoff of transferred funds, a schedule of interbank transfers made within a specified number of days before and after the balance sheet date (e.g., five business days) might be prepared and tested. Essentially, this procedure is performed when there is a higher assessed risk of fraud since the primary risk would be that cash is "double-counted" in two or more bank accounts in the same accounting period, for example due to "kiting," and there is a delay in items clearing the bank so they cannot be validated in a statement online. For each transfer, the schedule typically reflects the date recorded in the accounting records and the dates cleared in each bank statement. The auditor tests the schedule to ensure that transfers were recorded properly in same accounting period. Furthermore, the auditor will often trace transferred amounts to the bank statements for each bank and for any transfers not clearing the bank in the same accounting period as initiated in the accounting records. The auditor determines whether such amounts are properly reflected as reconciling items on the bank reconciliations. For example, if a transfer is recorded prior to period end and appears as a deposit on the bank statement of account A, but has not cleared on the bank statement of account B, the bank reconciliation for account B should reflect the transfer as an outstanding check. On the other hand, if a transfer appeared as a deposit on the bank statement of account A prior to period end, but was not recorded in the accounting records until after period end, this might be an indication that kiting has occurred.

The auditor might perform other substantive audit procedures in situations in which there are higher assessed risks of fraud. A proof of cash might be performed, for example, if there is a risk of unrecorded (or improperly recorded) cash receipts and disbursements or defalcation. (In addition to fraud risks, a proof of cash might be performed if the client has control deficiencies over the completeness of recording cash receipts and disbursements.) The proof of cash schedule is an expanded version of the bank reconciliation that reconciles:

- Beginning-of-the-period balances per the bank statement and the books.
- Current-period cash receipts per the bank statement to the corresponding items in the general ledger.
- Current-period cash disbursements per the bank statement to the corresponding items in the general ledger
- End-of-period balances per the bank statement and the books.

In addition, the auditor might modify procedures related to cash disbursements. For example, when the auditor has identified fraud risks, selected checks might be examined to determine unusual payees, endorsements, addresses, or amounts.

Physical examination (i.e., counting cash) is a necessary procedure on a typical audit engagement according to best practices. If cash on hand is clearly a material item as might be the case in a retail client such as a restaurant or grocery store, this procedure might be necessary to achieve the objective of existence. However, counting petty cash funds or other small cash accounts is normally not necessary. Although rarely the case, if the client keeps significant amounts of certificates of deposit on hand (or negotiable securities), the auditor may physically examine the certificates to determine if any have been pledged to secure indebtedness.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following generally accepted accounting principles (GAAP) applies to audits of cash balances?

   a. Material bank overdrafts will normally be presented as a separate caption in current liabilities.

   b. Amounts are considered cash equivalents if they have maturities of more than three months.

   c. Significant amounts of cash available for normal disbursement should be disclosed as noncurrent assets.

2. Which of the following would be considered a substantive procedure under AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluation the Audit Evidence Obtained*?

   a. Tests of details.

   b. Risk assessment procedures.

   c. Tests of controls.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following generally accepted accounting principles (GAAP) applies to audits of cash balances? **(Page 3)**

   a. Material bank overdrafts will normally be presented as a separate caption in current liabilities. [This answer is correct. Normally, bank overdrafts are presented as a separate caption among current liabilities. Similarly, material dollar amounts of checks dated at or before the balance sheet date (and reflected as outstanding checks on the bank reconciliation) that were not released until after the balance sheet date should be reclassified as accounts payable.]

   b. Amounts are considered cash equivalents if they have maturities of more than three months. [This answer is incorrect. Amounts that do not meet the definition of cash in FASB ASC 230-10 must be classified as cash equivalents or as other short-term investments. Generally, only highly liquid investments with original maturities of three months or less qualify as cash equivalents.]

   c. Significant amounts of cash available for normal disbursement should be disclosed as noncurrent assets. [This answer is incorrect. Noncurrent assets would include significant amounts of cash and cash equivalents that are not readily available for normal disbursements because of withdrawal restrictions. They should be appropriately disclosed, and consideration should be given to the classification of those amounts as noncurrent assets.]

2. Which of the following would be considered a substantive procedure under AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluation the Audit Evidence Obtained*? **(Page 4)**

   a. Tests of details. [This answer is correct. AU-C 330 states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of transactions, account balance, and disclosures and (b) substantive analytical procedures.]

   b. Risk assessment procedures. [This answer is incorrect. According to AU-C 500.06, *Audit Evidence*, appropriate audit procedures should be designed and performed to obtain sufficient appropriate audit evidence. AU-C 500.A10 states that those audit procedures consist of specific audit procedures which includes risk assessment procedures. Thus, per AU-C 500.A10, risk assessment procedures are not considered a substantive procedure.]

   c. Tests of controls. [This answer is incorrect. According to AU-C 500.06, *Audit Evidence*, appropriate audit procedures should be designed and performed to obtain sufficient appropriate audit evidence. AU-C 500.A10 states that those audit procedures consist of certain audit procedures which includes tests of controls. Thus, per AU-C 500.A10, tests of controls are not considered a substantive procedure.]

WORKPAPER CONSIDERATIONS

The workpapers listed below are common when performing the cash audit procedures. The workpaper content and the extent of the auditor's documentation will generally not be influenced by whether the workpapers are prepared in paper or electronic format. However, if the auditor uses electronic workpapers, any client-prepared schedules and detail need to be obtained in electronic format, if possible, to reduce the extent of paper documents that will be retained (or scanned) in the audit file.

a. A trial balance or lead schedule that reflects all cash accounts.

b. Standard bank confirmations for cash accounts selected for confirmation at the balance sheet date.

c. Bank reconciliations for all accounts with significant balances or activity.

Bank Confirmations

Preparation, mailing, and receipt of bank confirmations do not present major problems on most audits. Occasionally, because of poorly prepared confirmations or delays in processing them at the bank, audit inefficiencies can occur. The following suggestions may be helpful in avoiding unnecessary problems.

a. Before mailing, check the account numbers or certificate of deposit numbers entered on the confirmation to the bank statements or certificates. Transpositions in these usually long numbers are easy to make.

b. The standard bank confirmation form does not provide for the confirmation of certificates of deposit held in safekeeping by the bank. If certificates of deposit held in safekeeping are significant, consider confirming with the bank that the certificates of deposit are held in the client's name.

c. Ideally, the confirmation request is sent on or near the balance sheet date. Occasionally this is not possible, and the confirmation request is sent a number of months after the balance sheet date. There is a tendency for banks to automatically record the client's balance as of the month end closest to the date the request is received (instead of the date actually requested). Also, there is a tendency on November or January fiscal year-end clients for the bank to confirm the balance as of December 31. To avoid these problems, a caution note specifying the confirmation date stapled to the face of the standard confirmation form may be helpful.

d. It is always beneficial to retain a copy of the bank confirmation request in case a second mailing is needed. Also, consider a telephone call to the bank in lieu of a second letter.

e. If the client has only a few bank accounts, the auditor may send confirmations for every account. However, in some cases, the client may have one or two primary accounts and numerous secondary accounts that have minimal activity. In that case, the auditor may only send confirmations on the primary accounts. For the accounts not confirmed, the auditor can review the reconciliations for unusual reconciling items and agree the bank balance to the bank statement and the book balance to the general ledger.

f. Even if confirmations are sent for every account, inefficiencies can be avoided by relying on alternative procedures for secondary account confirmations not received. Rather than incur significant time trying to follow up on nonresponses for secondary accounts, the auditor might elect to agree the bank balance per the bank reconciliation to the bank statement or access the information directly by online inquiry, if available.

g. In addition to confirming bank accounts open at year-end, some auditors confirm all bank accounts closed during the year. The main purpose for this procedure is to detect unrecorded debt. However, it is the authors' opinion that this procedure is not the most effective for detecting unrecorded liabilities. Detail audit testing and analytical procedures on other balance sheet and income statement accounts are generally adequate to detect any material unrecorded debt.

The AICPA has a standard bank confirmation form that can be used to confirm checking accounts, savings accounts, other deposit accounts, and direct loans. The form is available with or without the auditor's name imprinted on it. Forms can be ordered by calling the AICPA at (888) 777-7077 or by using the online catalog at **www.aicpastore.com**.

Special Considerations on the Use of Electronic Bank Confirmations. Some financial institutions no longer respond to paper confirmation requests. Instead, they only respond to electronic confirmation requests submitted via a designated third party provider. Such providers serve as an intermediary who provides a secure link between the auditor and a validated financial institution. Auditors ought to be alert for financial institutions that might choose to only process electronic confirmation requests.

The definition of *external confirmation* in AU-C 505, *External Confirmations*, indicates that a confirmation in electronic form represents audit evidence. When using electronic confirmations, auditors consider the following risks to the reliability of such information:

- Response might not be from an authentic source.
- Respondent may not be knowledgeable about the information.
- Integrity of the transmission might be compromised.

The guidance at AU-C 505.A15 indicates that an electronic confirmation system or process that creates a secure environment for the transfer of confirmations that are received electronically, such as through fax or email, may mitigate the risks of interception or alteration of the confirmation. Auditors ought to consider the risks of sending confirmations electronically to prevent unauthorized release of confidential information to others. Sending and receiving via a secured portal, data encryption, and use of a third-party service provider with security protocols in place. Examples of cybersecurity measures firms can take when dealing with sensitive information such as confirmations are noted earlier in this section.

An electronic confirmation can be considered as a sufficient, valid confirmation response if the auditor is satisfied that the:

- Electronic confirmation process is secure and properly controlled.
- Information is obtained from a third party who is the intended respondent.
- Information is a direct communication in response to a request.

In determining whether the electronic confirmation process meets these requirements, the auditor might review an assurance trust services report or another auditor's report on that process. Typically, the auditor would determine if the report addresses the three risks noted earlier in this lesson. If not, the auditor may perform additional procedures to address those risks such as telephoning the sender of the information.

The use of an electronic confirmation process through a third party provider may provide the following benefits to the auditor:

- Provides a secure link to a valid financial institution.
- Provides significantly faster response times since the confirmation is received directly by a bank employee who is designated by the institution to respond to such confirmations.
- Removes the possibility of fraudulent or unauthorized recipients or interception of confirmation requests by the client.

Auditors consider whether the client's financial institution(s) requires the use of a third party confirmation service when performing engagement planning. By doing so, the auditor (a) will have appropriate time to learn about the service, (b) can determine whether the service addresses the risks discussed earlier in this lesson, and (c) can discuss modifications in the confirmation process with the client, as well as any additional fee considerations, if necessary. The improper use of paper confirmation requests in such situations may result in additional delays to complete the confirmation process, as well as to finalize the audit.

Currently, numerous financial institutions have designated Confirmation.com as the third party provider for submitting electronic confirmation requests. Confirmation.com is also a preferred provider for the AICPA and endorsed by the American Bankers Association. Additional information on Confirmation.com can be obtained via their website at **www.confirmation.com**.

Bank Reconciliations

Bank reconciliations are typically prepared by the client and copied for the workpapers. But bank reconciliations prepared in the client's monthly format may not be adequate for audit purposes. Also, if the bank statement date is other than the balance sheet date, some clients prepare the bank reconciliation as of the bank statement date rather than the balance sheet date. Time and effort can be wasted trying to adapt procedures to a poorly designed reconciliation. Accordingly, the following suggestions may be helpful:

a. Meet with the client before the balance sheet date and request that a special reconciliation format be used as of the balance sheet date.

b. The reconciliation ought to describe, by date and deposit slip total, all deposits in transit. Any interbank deposits need to be identified.

c. The reconciliation ought to include a complete listing of outstanding checks, showing check number, date written, payee, and amount. That information will be needed for performing tests with subsequent bank statement activity and for reconciling accounts payable confirmations during application of liability-related procedures. Avoid letting the client give you long lists of outstanding checks that do not identify these key elements.

d. Other reconciling items need to be clearly described and dated on the reconciliation.

Other Workpaper Considerations

Audit efficiency may also be improved by considering the following workpaper suggestions:

a. *Interbank Transfers.* An interbank transfer schedule may be necessary for an entity with numerous bank accounts and numerous interbank transfers where the risk of material misstatement is higher. In most smaller audits, however, this procedure might be accomplished in connection with testing the bank reconciliations. When vouching deposits in transit, determine whether any of those deposits represent interbank transfers. Then compare deposits in transit for incoming transfers with the corresponding outstanding check from the other account for the outgoing transfers. If there is no corresponding outstanding check, determine whether the client recorded the outgoing transfer. This approach can be documented merely by signing the audit program step and cross-referencing each applicable deposit in transit to the corresponding outstanding check. However, when using this approach, it is important for the auditor to review significant deposits in transit on all bank accounts (even accounts where limited procedures are otherwise performed) to determine whether those deposits represent interbank transfers. This is sometimes accomplished by placing copies of bank reconciliations for all accounts in the workpapers.

b. *Elaborate Documentation.* A common fear among auditors is that failure to perform substantial audit procedures on any schedule included in the workpapers results in substandard auditing. While it is important to document procedures performed on a workpaper, remember that many workpapers may only be used for scanning for reasonableness, e.g., bank reconciliations of infrequently used and immaterial bank accounts. Avoid the temptation of documentation overkill on those schedules.

c. *Schedule of Several Bank Reconciliations.* In some situations, one workpaper reflecting the reconciliation of several small bank accounts may be more practical. Procedural documentation can be minimized.

d. *Standard Tickmark Sheet.* Audit procedures performed on each bank account can be repetitive. Accordingly, a standard tickmark sheet may be more efficient than repeatedly documenting the same procedures.

e. *Memos.* A brief memo may be more efficient for documenting work performed on several small bank accounts. However, memos need not be prepared if they are redundant and restate the steps performed on the audit program. Memos ought to be used only to reduce the documentation on numerous workpapers or to discuss the cause and resolution of complex audit problems.

f. *Documenting the Proof of a Bank Statement.* In the rare situation where a bank statement needs to be proved, a memo regarding the proofing procedures may be more appropriate than including copies of the bank statement and other documentation.

g. *Program Sign Off.* In some cases, an auditor may consider signing off and dating an audit program as adequate documentation of procedures performed, especially scanning procedures. However, for tests involving a selection of items or inquiry, there are minimum documentation requirements.

COMMON OVER (UNDER) AUDITING TENDENCIES

As mentioned earlier, there is a common tendency to overaudit cash. The auditor designs the nature, timing, and extent of substantive procedures based on the assessed risks of material misstatement at the relevant assertion level and need not be tempted to apply procedures that are not necessary given the level of assessed risks. The following lists of over- and underauditing tendencies are not all-inclusive and are intended as general indications.

Overauditing Tendencies

The following overauditing tendencies are common:

a. *Counting Cash on Hand.* Normally, this procedure is not necessary.

b. *Testing Immaterial Cash Accounts.* There is a tendency to perform detail testing of the year-end reconciliations of all bank accounts. However, in many cases only one account, the general disbursements and receipts account, has enough activity or reconciling items to require cutoff testing. Sufficient assurance on payroll bank accounts and other small accounts can generally be obtained by confirming the bank balance (or reviewing the bank statement) and scanning the reconciling items for unusual entries.

c. *Workpaper Inefficiencies.* Often elaborate workpapers are prepared out of tradition when they may not be necessary, e.g., interbank transfer schedules.

d. *Matching of Individual Items on Deposit Slips to Accounts Receivable.* This procedure is a traditional fraud procedure to discover lapping. Fraud procedures are not necessary unless they are performed in response to identified fraud risks.

e. *Immaterial Reconciling Items.* Significant time and effort can be spent trying to determine the cause of many small reconciling items on a bank reconciliation. If an auditor is satisfied as to the nature of the reconciling item, any concerns over the cause can be expressed in a management letter. The auditor might also suggest a separate engagement at a later date to evaluate the causes of problems with the accounting system.

f. *Routinely Performing a Proof of Cash.* A proof of cash is a bank reconciliation that includes not only the prior-period and current-period balances but also reconciles the book receipts and disbursements for the period(s) with the bank statement(s). A proof of cash can provide evidence about the existence and completeness assertions for transactions that were recorded on the books or bank statements; however, many of the other audit procedures discussed earlier in this lesson are more efficient and just as effective. A proof of cash is essentially a fraud procedure aimed at detecting recurring cash defalcations. Best practices indicate that it would only be performed if misappropriation of cash is an identified fraud risk or if there is a high risk of material misstatement of cash. In such cases, it would be performed for the entire audit period.

g. *Unnecessary Vouching of Transactions.* Companies that invest idle funds in certificates of deposit often renew them over an extended period. It is usually unnecessary to vouch each certificate transaction, especially if those certificates have been confirmed at each year end.

Underauditing Tendencies

Because the temptation is to design audit procedures to obtain a precise accounting for cash, there is a greater tendency to overaudit than to underaudit. However, GAAP presentation requirements are often overlooked, and facts found during the audit of cash may not be properly related to other audit areas. The following tendencies may occur:

a. *Classification Deficiencies.* Short-term investments vs. cash equivalents, restricted cash, cash overdrafts, and held checks may not be identified because of a lack of familiarity with the definitions and disclosure requirements for these items.

b. *Relating Facts to Other Audit Areas.* Information regarding interest rates, balances, and collateral on debt may not be related to corresponding audit work on debt. Likewise, the auditor may be unable to reconcile accounts payable confirmations from vendors without relating outstanding checks noted during the audit of cash.

c. *Failure To Test Completeness of Outstanding Check List.* The outstanding check lists of significant bank accounts ought to be tested for completeness. That test is generally accomplished by tracing canceled checks clearing the subsequent bank statements to the outstanding check list. Vouching outstanding checks (that is, tracing from the bank reconciliation to the canceled checks) does not test completeness.

CASE STUDIES AND OTHER CONSIDERATIONS

Case Studies

The following case studies illustrate common cash audit problems.

Proof of a Bank Statement. The client receives the subsequent period statement and reconciles the account as usual. Upon arriving to perform cash audit procedures, the auditor decides to test the subsequent period bank statement to determine that it is complete and unaltered. However, that bank statement contains over 300 checks. What does the auditor do to verify the completeness and integrity of the subsequent bank statement?

Solution. The auditor bears in mind that a subsequent period bank statement is obtained to test the bank reconciliation (when considered necessary based on the assessment of risks). That is, it is obtained to substantiate the deposits in transit and to determine whether the outstanding check list is complete. The completeness of the outstanding check list is tested by verifying that it includes all checks that (a) clear in the subsequent period and (b) are dated as of the previous period. When a bank statement is obtained directly from the bank, it provides stronger evidence than a bank statement obtained from the client. Accordingly, when subsequent statements are obtained from the client, additional procedures are *sometimes* necessary to determine that the client has not altered the statement. Those additional procedures may include the following:

a. Examining the bank statement for apparent changes.

b. Obtain online account information directly from the bank, such as daily ending account balances by individual account and transaction level activity of checks clearing and deposits posting. The auditor ought to have the client access and print the online information in his or her presence. (In some cases, the auditor might also apply additional procedures to determine the validity of the online website.)

Held Checks. The auditor notes that the bank reconciliation has a long list of checks in numerical sequence, all dated December 31, the balance sheet date. What procedure might be performed to determine if there are any "held checks" (checks dated on December 31 but not released until the following month)?

If the auditor was observing inventory on December 31, the solution to this problem might be stopping by the accounting department and recording the last check number written *and mailed* at the end of the day. The auditor could then later compare that check number to the check numbers on the outstanding check list and question any additional checks dated on December 31. Alternatively, for checks in question, the auditor can record on the workpaper copy of the bank reconciliation the date of the first bank endorsement of the checks clearing in the subsequent period. A consistent trend of long clearing delays may indicate a held check problem that might result in a reclassification to accounts payable.

Surprise Cash Count. The auditor decides to perform a surprise count of cash register totals for a small family-owned grocery store. He times the surprise count when little traffic is in the store to avoid disrupting normal customer check-outs. The store has three cash registers, and it ordinarily takes only about fifteen minutes to count each one. When no one is in the store, the auditor, accompanied by the owner, arrives at the check-out stands to count the cash. Each clerk is asked to observe the count at the clerk's register. Suddenly, three bus loads of kids (on the way to a ski trip) enter the store and begin lining up at the check-out counters. What does the auditor do?

Solution. Exchange clerks, having one clerk count the other's register while the auditor observes. This procedure is also effective in counting numerous teller windows at a small bank.

Bank Does Not Return Canceled Checks with Bank Statements. The client's bank does not return canceled checks to the client along with the monthly bank statement. The auditor wonders if it is possible to perform an effective audit without examining canceled checks (for example, when auditing the main disbursements account or as support for transactions in other audit areas) and what to do in the present circumstances.

Solution. Banks that do not return canceled checks and other documentation usually provide access to electronic images of the front and back of canceled checks or provide complete details (payee, amount, date, and check number) on the bank statement. Depending on the circumstances, the auditor might apply one or more of the following procedures to obtain sufficient appropriate evidence about cash disbursements:

a. Through the client, arrange in advance to receive directly from the bank a copy of the electronic images of cancelled checks. Alternatively, have client personnel access the client's online banking information under the auditor's direct observation. (In such cases, the auditor may need to take appropriate steps to determine the validity of the online banking information.)

b. If the bank lists the payee on the bank statement as well as the check number, amount, and date paid, this detail may provide sufficient evidence of the actual payee listed in the client's records.

c. The details of the disbursement can be confirmed with the payee if neither the check nor a sufficiently detailed bank statement is available and the auditor wants evidence independent of the client's records.

d. The auditor may be able to rely on a combination of data on the bank statement (check number, amount, and date paid), the client's internally generated information about the disbursement, and client control procedures related to disbursements such as the following:

   (1) Use of prenumbered checks and numerical control of checks used.

   (2) Recording of check numbers in the disbursements journal.

   (3) Designation of authorized check signers.

   (4) Restricted access to checks and signature plates (or alternative signature process).

   (5) Approval of payments, signing of checks, and timely preparation of bank reconciliations by persons other than the one who prepares checks and posts disbursements to the accounts.

Lengthy Confirmation Response Times. One of the auditor's largest clients has 25 significant bank accounts for its divisions located throughout the United States. In previous years, confirmation responses have sometimes taken over a month to receive and, in many situations, have required multiple requests, including phone calls. In the previous audit, the auditor's report was delayed because confirmations could not be obtained on a timely basis for several of the largest bank accounts. What should the auditor consider for the upcoming audit?

Solution. The auditor may wish to consider the feasibility of using the services of an electronic confirmation provider. In doing so, the auditor would want to consider the advantages of using the confirmation provider for all of the firm's audits. Some considerations in choosing a provider might include:

- *Are the client's banking relationships considered to be "in-network" or "out-of-network" for the confirmation provider?* Confirmation providers often establish a network of participating banks, which provides the

advantage of authenticating and authorizing both the entities and the individuals responding to requests. In such cases, the auditor is not required to perform additional authentication and authorization procedures.

- *Does the provider receive a trust services report related to security, availability, processing integrity, confidentiality, or privacy (SOC 3 report) and/or other auditor's report on the process?* The auditor needs to be satisfied that the risks listed earlier have been satisfactorily addressed.

- *What are the costs versus benefits?* The auditor needs to determine the costs of the services and compare them to time saved in follow-up responses. The auditor also needs to consider the intangible benefits of a potential reduction in audit delays and improved client relationships by avoiding last-minute delays.

- *What is the time frame to adopt the confirmation process?* The auditor would explore with the provider the necessary time frame to adopt the system, required communications with clients, and in-firm training on the use of the confirmation process.

RESPONDING TO FRAUD RISK

The auditor may determine that an audit response is necessary. Audit responses may be overall or specific. Overall responses, such as assigning more experienced personnel, introducing a significant element of unpredictability, and as considering the extent of supervision planned for the audit, affect the overall conduct of the audit. Auditors generally use overall responses to address fraud risks that are pervasive to the financial statements. Specific responses involve the nature, timing, and extent of further audit procedures. Specific responses are used to address fraud risks in individual audit programs, that is, at the account balance, transaction class, or financial statement assertion level.

Numerous different types of fraud schemes may be used to perpetrate either fraudulent financial reporting or misappropriation of assets. Auditors need an understanding of fraud schemes and how they are perpetrated, concealed, detected, and prevented so they can design appropriate audit responses and advise their clients about fraud prevention and detection matters. Examples of common fraud schemes related to cash and procedures that may be performed in response to those schemes are provided for both misappropriation of assets (Exhibit 1-1) and fraudulent financial reporting (Exhibit 1-2). For misappropriation of assets, Exhibit 1-1 also lists the symptoms (also called red flags or indicators) auditors may observe that indicate the presence of a particular fraud scheme. For fraudulent financial reporting schemes presented in Exhibit 1-2, symptoms generally relate to fraud risk factors such as the desire to minimize reported earnings for tax-motivated reasons. Those risk factors may provide an incentive or pressure to manipulate the financial statements.

Exhibit 1-1

Common Cash Fraud Schemes, Symptoms, and Related Audit Responses—Misappropriation of Assets

Fraud Scheme	Symptoms	Audit Responses[a]
Skimming all or part of a cash sale.	• Cash sales or receipts differ from normal or expected patterns. • Cash deposit totals differ from normal or expected patterns. • Inventory discrepancies. • Unusual amount or pattern of cash over/short. • Receipts in currency decrease, while customer checks and credit card receipts increase or remain constant. • Customer complaints. • Declining gross profit.	• Compare inventory sold to the change in inventory. • Analyze gross profit.
Theft of a daily deposit.	• Cash sales or receipts differ from normal or expected patterns. • Cash deposit totals differ from normal or expected patterns. • Inventory discrepancies. • Lack of segregation of duties. • Missing deposit slips. • Missing sales invoices. • Unusual journal entries or unusual items on the bank reconciliation. • Differences between daily list of receipts and deposits on bank statement.	• Compare bank deposits to cash receipts records. • Prepare proof of cash. • Review journal entries. • Review bank reconciliations.
Less cash schemes (that is, shorting the deposit).	• *Less cash* on deposit tickets. • Cash sales or receipts differ from normal or expected patterns. • Cash deposit totals differ from normal or expected patterns. • Inventory discrepancies. • Unusual reconciling items on bank reconciliations. • Unusual journal entries affecting cash accounts. • Deposits per the bank statement that do not match the company's copy of deposit tickets. • Lack of segregation of duties.	• Compare bank deposits to cash receipts records. • Prepare proof of cash. • Review bank reconciliations. • Review journal entries.

Fraud Scheme	Symptoms	Audit Responses[a]
Voids and sales returns schemes.	• Unusual or unexpected voids or sales returns. • Cash sales or receipts differ from normal or expected patterns. • Cash deposit totals differ from normal or expected patterns. • Inventory discrepancies. • Unusual activity on the daily cash register tape. • Discrepancies between sales prices and list prices.	• Review daily cash register tapes. • Compare sales prices to list prices. • Compare inventory sold to the change in inventory. • Inspect and account for returned merchandise. • Match sales returns with original sales. • Confirm sales returns with customers. • Analyze voids and sales returns.
Theft of cash on hand.	• Discrepancies between the cash count and the account balance. • Unusual or unexpected fluctuations in cash on hand. • Personal checks included in cash funds (swapping checks for cash). • Cash shortages. • Increased use of petty cash fund.	• Conduct surprise cash counts.

Note:

[a] In addition to the specific responses listed, the auditor may also interview client personnel in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

* * *

Exhibit 1-2

Common Cash Fraud Schemes and Related Audit Responses—Fraudulent Financial Reporting

Fraud Scheme	Audit Responses[a]
Holding cash receipts records open after the balance sheet date or closing cash disbursement records early.	• Inspect deposits and canceled checks for dates they cleared the bank and note any unusual patterns.
Kiting.	• Prepare and review interbank transfer schedule.
Improperly accounting for held checks.	• Inspect deposits and canceled checks occurring around period end for dates they cleared the bank. • Examine support for held checks.
Overstating capitalized interest to increase cash flow from operations.	• Test the validity of interest capitalized during the period.

Note:

[a] In addition to the specific procedures listed, the auditor may also interview client personnel in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

* * *

A risk of misappropriation of assets may exist in many entities. However, the auditor is not responsible for immaterial fraud, and many frauds involving misappropriation of assets are not material to the financial statements. Consequently, auditors need not automatically perform additional procedures related to misappropriation simply because a risk of misappropriation exists. The auditor should develop an audit response for identified risks of *material* misstatement due to fraud.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Leona, a CPA, is performing cash audit procedures for Shasta, Inc. Which of the following workpapers is commonly included when performing this type of audit?

   a. Bank reconciliations for all of the client's accounts with significant balances or activity.

   b. A schedule that will test depreciation.

   c. A schedule of trade accounts that are payable by vendor.

   d. Standard bank confirmations for all of the client's accounts.

4. Which of the following suggestions would you give auditor A to improve the design of the bank reconciliation and, thus, increase the efficiency of a cash audit?

   a. Include a complete list of outstanding checks.

   b. Include an interbank transfer schedule.

   c. Include as much documentation as possible.

   d. Include documentation of the proof of a bank statement.

5. The auditors in all of the scenarios below are auditing the cash component of their client's balance sheets. In which of the following scenarios has the auditor performed the correct procedure to mitigate the problem at hand?

   a. Wes decides that he can perform the audit without implementing audit procedures.

   b. Annalise notes that her client's bank reconciliation includes a long list of checks all dated December 31 (the balance sheet date). The checks are in numerical order. Annalise records (on the workpaper copy of the bank reconciliation) the date of the first bank endorsement of the checks that were cleared in the subsequent period.

   c. Nate plans to perform a surprise count of cash register totals for a small business at a time when the store has few customers. Each clerk is asked to observe each count. A mass of customers arrive just as the first count begins. Nate instructs all customers to wait until the count is finished before making purchases.

6. Jason is a CPA hired to audit Halo Inc. During his audit, Jason discovers that the client is not properly accounting for held checks. What should be his audit response?

   a. Test the validity of interest that was capitalized during the audit period.

   b. Inspect deposits and cancelled checks that occur around period end for the dates they cleared the bank.

   c. Inspect deposits and cancelled checks for the dates that they cleared the bank and note unusual patterns.

   d. Compare sales prices to list prices and compare inventory sold to the change in inventory.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Leona, a CPA, is performing cash audit procedures for Shasta, Inc. Which of the following workpapers is commonly included when performing this type of audit? **(Page 9)**

   a. Bank reconciliations for all of the client's accounts with significant balances or activity. [This answer is correct. There are three types of workpapers that are common when performing the cash audit procedures: a trial balance or lead schedule that reflects all cash accounts, a standard bank confirmation for cash accounts selected for confirmation at the balance sheet date and bank reconciliations for all accounts with significant balances or activity.]

   b. A schedule that will test depreciation. [This answer is incorrect. This workpaper may be used when performing property audit procedures rather than cash audit procedures, though detailed property records could be used instead.]

   c. A schedule of trade accounts that are payable by vendor. [This answer is incorrect. This workpaper would be used to document the performance of the liabilities audit procedures rather than cash.]

   d. Standard bank confirmations for all of the client's accounts. [This answer is incorrect. Standard bank confirmations are commonly included in workpapers for the audit of cash; however, they would not necessarily be provided for all of an entity's accounts. These confirmations would be provided for cash accounts selected for confirmation at the balance sheet date. If the client has one or two primary accounts and numerous secondary accounts that have minimal activity or risk, confirmations may only be requested on the primary accounts.]

4. Which of the following suggestions would you give auditor A to improve the design of the bank reconciliation and, thus, increase the efficiency of a cash audit? **(Page 11)**

   a. Include a complete list of outstanding checks. [This answer is correct. The reconciliation should include a complete listing of outstanding checks, showing check number, date written, payee, and amount. That information will be needed for performing tests with subsequent bank statement activity and for reconciling accounts payable confirmations during application of liability-related procedures.]

   b. Include an interbank transfer schedule. [This answer is incorrect. An intrabank transfer schedule is a separate workpaper from the bank reconciliation. This schedule is most helpful for an entity with numerous bank accounts and numerous interbank transfers where the risk of material misstatement is higher.]

   c. Include as much documentation as possible. [This answer is incorrect. A common fear among auditors is that failure to perform substantial audit procedures on any schedule included in the workpapers results in substandard auditing. However, auditors should avoid the temptation of documentation overkill on those schedules.]

   d. Include documentation of the proof of a bank statement. [This answer is incorrect. In a rare instance where a bank statement need to be proven, a memo regarding the proofing procedures may be more appropriate than including copies of the bank statement and other documentation. However, this is a rare occurrence and is not considered the best method to improve the design of the bank reconciliation and, thus, increase the efficiency of a cash audit.]

5. The auditors in all of the scenarios below are auditing the cash component of their client's balance sheets. In which of the following scenarios has the auditor performed the correct procedure to mitigate the problem at hand? **(Page 13)**

   a. Wes decides that he can perform the audit without implementing audit procedures. [This answer is incorrect. Wes has quite a few options to mitigate this problem. Omitting the audit procedures from his process is not the correct response. He could ask the client to communicate with the bank to get the cancelled checks, or he could try to obtain them using another method, such as online. Or, he could perform additional procedures, such as relying on a combination of data on the bank statement, the client's internally generated information about the disbursement, and client control procedures related to the disbursement.]

   b. Annalise notes that her client's bank reconciliation includes a long list of checks all dated December 31 (the balance sheet date). The checks are in numerical order. Annalise records (on the workpaper copy of the bank reconciliation) the date of the first bank endorsement of the checks that were cleared in the subsequent period. [This answer is correct. In this situation, Annalise has two options to determine if there are any held checks. If she was observing inventory on December 31, she should stop by the accounting department to record the last check number written and mailed at the end of the day. Alternatively, Annalise can record on the workpaper copy of the bank reconciliation the date of the first bank endorsement of the checks clearing in the subsequent period. A consistent trend of long clearing delays could indicate a held check problem.]

   c. Nate plans to perform a surprise count of cash register totals for a small business at a time when the store has few customers. Each clerk is asked to observe each count. A mass of customers arrive just as the first count begins. Nate instructs all customers to wait until the count is finished before making purchases. [This answer is incorrect. To allow the store to continue regular business, Nate should have one clerk count another clerk's register while he watches. This allows some of the clerks to check out the influx of customers.]

6. Jason is a CPA hired to audit Halo Inc. During his audit, Jason discovers that the client is not properly accounting for held checks. What should be his audit response? **(Page 18)**

   a. Test the validity of interest that was capitalized during the audit period. [This answer is incorrect. This audit response would be used if the client were overstating capitalized interest to increase cash flow from operations.]

   b. Inspect deposits and cancelled checks that occur around period end for the dates they cleared the bank. [This answer is correct. This response would address improper accounting for held checks. The auditor could also examine support for held checks.]

   c. Inspect deposits and cancelled checks for the dates that they cleared the bank and note unusual patterns. [This answer is incorrect. This audit response would be used if the client were holding cash receipts records open after the balance sheet date or closing cash disbursement records early.]

   d. Compare sales prices to list prices and compare inventory sold to the change in inventory. [This answer is incorrect. This audit response would be appropriate for voids and sales returns schemes.]

Lesson 2: Property

INTRODUCTION

The property component of the balance sheet often amounts to a significant portion of total assets. However, property usually requires a much smaller proportion of total audit time. This is because transactions that affect property are usually relatively few in number. Also, the accounts may not change materially from year to year, and some accounts, such as land, may not change for years at a time. Asset accounts in the property component of the balance sheet usually include the following:

a. Property ordinarily not subject to depreciation or depletion, such as land used for industrial or commercial purposes or long-lived assets held for sale.

b. Property subject to depreciation, such as buildings, machinery and equipment, automobiles and trucks, office furniture and equipment, tools, patterns, dies, etc.

c. Property subject to depletion, such as timber, oil, and mining properties.

d. Property leased under lease agreements that meet the criteria for capitalization under GAAP. (See discussion on recent accounting standards later in this section.)

Learning Objectives:

Completion of this lesson will enable you to:

- Identify audit evidence procedures and workpaper considerations that are appropriate for auditing property and describe problems with auditing property, including overauditing, underauditing, and fraud risk.

Accounting Standards

Accounting principles that affect property include both measurement and disclosure principles. The measurement principles for property are:

a. Property should be stated at cost unless it is clear that there has been a permanent impairment in value that should be reflected in the accounts. Impaired assets should be stated at fair value.

b. Property accounts should reflect the total cost of property in service. This requires sound policies for capitalizing additions and major replacements and removing the cost of property physically retired from service or abandoned.

c. Property cost may include various indirect costs, such as interest on borrowed funds, in addition to the direct cost of acquiring the asset.

d. Depreciation or depletion should be allocated over the estimated useful lives of the properties on a systematic and rational basis. Asset lives should be estimated based on the normal period of time such property should be useful for the purpose acquired.

e. Long-lived assets held for sale should be carried at the lower of carrying amount or fair value.

Cost of acquisition includes not only the invoiced amount for the asset but also such items as freight, sales tax, transportation, and installation cost. Generally, property acquired in exchange for notes, mortgages, capital stock, or other noncash consideration should be recorded at amounts equivalent to the fair values of either the asset acquired or the consideration given in exchange, whichever is more clearly evident. In a "basket purchase," where several items are purchased for a single price, the gross purchase price should be allocated to the individual items based on the relative fair values of the items. Assets constructed by the client should include interest, labor, and overhead costs in addition to materials cost.

The primary disclosure requirements for property include:

a. Disclosure of balances for major classes of depreciable assets.

b. Disclosure of accumulated amounts of depreciation, by major class or in total.

c. Description of depreciation methods.

d. Depreciation expense for the period.

e. Disclosure of amounts of capitalized interest included in balances.

f. Disclosures required for capital leases. (See discussion on recent accounting standards later in this section.)

g. Disclosures required when impaired assets have been written down.

h. Disclosures required when the entity carries long-lived assets held for sale.

i. Disclosures required when the company has long-lived asset retirement obligations.

New Leasing Standard

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which among other things, requires the recognition of lease assets and lease liabilities by lessees, including for those leases classified as operating leases under previous GAAP, along with the disclosure of key information about leasing arrangements. When effective, the ASU will supersede FASB ASC 840, *Leases*, and add Topic 842, *Leases*, to the FASB ASC. In addition to replacing FASB ASC 840 with FASB 842, the ASU amends and supersedes a number of other Topics throughout the FASB ASC. The following paragraphs discuss certain elements of the new standard.

Lessee Accounting. Lessees are required to classify a lease as a *finance lease* if certain criteria are met as of the lease commencement date. These criteria are similar to those for capital leases to current GAAP. Otherwise, the lease should be categorized as an *operating lease*. Unless the lessee elects an accounting policy for certain short term leases (as noted later in this section), a right-of-use asset and a lease liability should be recognized as of the lease commencement date.

For finance leases, after the commencement date, the lessee recognizes the following expenses for each period: (a) amortization expense for the right-of-use-asset and interest expense related to the lease liability, (b) variable lease payments incurred in the period, which were not included in the lease liability, and (c) impairment expense, if appropriate, related to the right-of-use asset. The amortization of the right-of-use asset should be calculated on a straight-line basis, unless another systematic basis is more representative of the pattern of benefits received from the asset.

For operating leases, after the commencement date, the following expenses are recognized in each period after the commencement date: (a) unless the right-of-use asset is impaired, lease expense representing the straight-line (or other more representative basis) allocation of the remaining cost of the lease over the remaining lease term, (b) variable lease payments incurred in the period which were not included in the lease liability, and (c) impairment expense, if appropriate, related to the right-of-use asset.

A lessee may elect as an accounting policy, by class of underlying asset, to not recognize a right-of-use asset and lease liability for a short-term lease. A short-term lease is a lease that has a term of 12 months or less as of the commencement date and does not have a purchase option that the lessee is reasonable certain to exercise. If this policy is elected, the lease payments should be expensed on a straight-line basis over the lease term. Variable lease payments should be recognized in the period that the obligation is incurred.

Lessor accounting. For lessors, if a lease meets any of the criteria that results in a finance lease for a lessee, it is classified as a *sales-type lease*. Otherwise, it should be classified as an *operating lease* unless the present value of the lease payments and guaranteed residual value is equal or exceeds substantially all of the fair value of the leased

asset. If so, and if the collection of the lease payments and guaranteed residual value are probable, the lease is classified as a *direct financing lease*. Lessor accounting under ASU 2016-02 is substantially unchanged from current leasing standards. The vast majority of operating leases should continue to be classified as operating leases. However, ASU 2016-02 makes specific changes to matters such as certain glossary terms. In addition, certain aspects of the lessor accounting model have been aligned with the new revenue recognition guidance introduced by ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).*

Other. Among other things, the new FASB ASC 842 also provides guidance on sale and leaseback transactions. Also, leveraged lease classification and accounting is eliminated by FASB ASC 842 for new leases that commence after the effective date of ASU 2016-02. However, lessors will continue to account for leveraged leases that commenced prior to the effective date of the new standard using current GAAP.

Recent Exposure Drafts. As of the date of this course, the FASB has issued three proposed ASUs that would amend the lease guidance in Topic 842 for matters involving land easements, various technical corrections and other narrow issues, and certain other targeted improvements. For entities that have not adopted ASU 2016-02, the effective date for such proposals would be the same as those in ASU 2016-02. Readers should refer to **www.fasb.org** for the current status of these proposals.

Effective Date. The ASU is effective for entities other than public business entities, certain not-for-profit entities, and certain employee benefit plans for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. Users should refer to the ASU for additional information about specific transition and disclosure amendments and requirements. Due to the delayed effective dates of ASU 2016-02, this course has not been updated for the requirements of ASU 2016-02. As the effective date nears, a future edition of this *Course* will incorporate any necessary revisions related to the ASU. Users may download the ASU from the FASB's website at **www.fasb.org** or from Checkpoint at **checkpoint.riag.com**. *PPC's Guide to GAAP* and *PPC's Guide to Preparing Financial Statements* provide additional detail on the amendments in ASU 2016-02.

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

According to AU-C 500.06, *Audit Evidence*, appropriate audit procedures should be designed and performed to obtain sufficient appropriate audit evidence. AU-C 500.A10 states that those audit procedures consist of risk assessment procedures, tests of controls, and substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor's opinion, but do not, by themselves, provide sufficient appropriate audit evidence. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, at AU-C 330.18, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The auditor uses relevant assertions in assessing the risk of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

Relevant Assertions for Property

The relevant assertions for property generally are as follows:

- Existence or occurrence (E/O)—Property, plant, and equipment reflected in the accounts exists and is physically on hand. The costs and related depreciation applicable to all sold, abandoned, damaged, or obsolete property have been properly removed from the accounts. Property, plant, and equipment transactions occurred and pertain to the entity.

- Completeness (C)—All property, plant, and equipment transactions have been recorded. Property, plant, and equipment reflected in the accounts represent a complete listing of the capitalizable cost of assets purchased, constructed, or leased by the entity and related disclosures are complete.

- Rights or obligations (R/O)—Property, plant, and equipment are owned by the entity.

- Valuation or allocation (V)—Property, plant, and equipment are valued in accordance with GAAP. The balances in the depreciation allowance accounts are reasonable, considering the expected useful lives of the property units and estimated salvage value, and depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable basis consistent with that used in prior years. Accordingly, the net carrying values of property presented in the financial statements are expected to be recoverable in the ordinary course of business.

- Cutoff (CO)—Property, plant, and equipment are recorded in the proper accounting period.

- Accuracy or classification (A/CL)—Property, plant, and equipment are properly classified in the balance sheet; noncapitalizable costs are properly expensed, and capitalizable costs are excluded from maintenance or other expense accounts. Liens, significant fully depreciated assets, idle property, and property held for investment are identified and properly disclosed. The financial statements also include disclosure of information about property, plant, and equipment required by GAAP.

Substantive Audit Procedures for Property

Transactions that affect property usually are relatively few in number. In addition, even when transactions are material, the accounting generally is not complex. Accordingly, auditors often assess the risk of material misstatement related to property as low. (In contrast, transactions that involve a high degree of judgment and subjectivity, amounts derived from accounting estimates, and unusual or complex transactions have a higher risk of material misstatement.)

Because the property component of the balance sheet generally is material, auditors generally need to design and perform substantive procedures for all relevant assertions related to property. However, when the risk of material misstatement is low, substantive analytical procedures generally provide the auditor with sufficient appropriate audit evidence for relevant assertions related to property, and tests of details, such as (a) vouching property additions, retirements, and maintenance accounts, and (b) recalculating depreciation, are often not necessary. In addition, because auditors generally will have audited the property accounts in prior years, current period substantive procedures can focus primarily on additions and dispositions during the year.

Examples of substantive analytical procedures at the account balance level to obtain audit evidence for relevant assertions related to property are as follows:

- Compare activity and balances in the property and accumulated depreciation and amortization accounts with balances for prior years or other expectations such as the capital budget and investigate any unexpected results.

- Inquire of the client about whether there has been any change in depreciation or amortization lives or methods and whether there are significant amounts of fully depreciated or amortized assets.

- Scan the schedule of property and consider whether the lives of assets are reasonable, whether depreciation and amortization methods are in accordance with GAAP and consistent, and whether depreciation and amortization expense for the year appears reasonable.

- Consider whether conditions exist that indicate assets may not be recoverable, that is, they may be impaired.

The following procedures performed during other aspects of the audit also contribute to audit evidence for property:

- Observing major additions, retirements, damaged, or obsolete property (for example, during inventory observation or plant tours) and relating them to recorded amounts provide audit evidence to support the existence, completeness, and valuation assertions.

- Inspecting loan documents, lease agreements, debt confirmations and minutes for evidence of liens, pledged assets, financing arrangements, capitalizable leases, and property held for investment provide audit evidence to support the rights/obligations and completeness assertions, as well as assertions related to presentation and disclosure. (Many of these procedures may be done as part of the general procedures programs.)

If the auditor's assessment of the risks of material misstatement for one or more assertions is high, additional substantive procedures such as the following might be performed for property:

- Testing of mechanical accuracy of the schedule of opening and ending property balances and transactions.

- Testing of additions to property by vouching the costs and authorization through examination of supporting documentation.

- Inspecting lease agreements for significant assets and determining whether the assets have been properly capitalized.

- Reviewing analyses of repairs and maintenance and vouching to determine whether significant or unusual items should have been capitalized.

- Testing of dispositions of property by vouching proceeds and recalculating whether the disposition has been properly reflected in the accounting records under GAAP.

- Testing depreciation expense through additional analytical procedures or recomputation on selected assets.

- Reviewing impairment analyses and testing the client's method and assumptions.

- Inquiring of the client and using the results of procedures in other areas to determine the propriety of the identification and classification of items such as idle property, property held for sale, property subject to liens and encumbrances, and capitalized leases.

- For risks of fraud, physically counting fixed assets.

The primary matters related to presentation and disclosure that are considered in the audit programs at the account balance and transaction class level are (a) the proper classification of accounts for financial statement presentation (classification) (for example, property held for sale or for investment) and (b) ensuring that the workpapers include information needed for disclosures and that such information has been subjected to appropriate audit procedures (occurrence, accuracy, and valuation). Accuracy and classification is further considered by agreeing or reconciling the financial statements to the general ledger. The completeness and understandability of disclosures are ordinarily considered in the steps in the general auditing and completion program.

While performing substantive audit procedures for property, the auditor needs to be alert for signs that any significant assets may be impaired. The following conditions may indicate that an asset has been impaired:

a. A significant decline in the market price of the asset. (This applies particularly to assets that are held for sale or expected to be sold in the foreseeable future.)

b. A significant adverse change in the extent or manner of the asset's use (for example, a significant decline in the use of a machine).

c. A significant adverse physical change in an asset (for example, physical damage).

d. A significant adverse change in legal factors or in the business climate that affects the value of the asset or an adverse assessment or action by a regulator (for example, a machine suddenly becomes obsolete, or changes in environmental regulations significantly restrict the use of a particular machine or plant).

e. Significant cost overruns beyond the amount originally expected to be needed to acquire or build the asset.

f. A current period operating or cash flow loss combined with a history of operating or cash flow losses associated with the use of a long-lived asset.

g. Budgets or prospective financial information showing continuing losses associated with a revenue producing asset (for example, a plant site is expected to generate significant operating losses for the foreseeable future).

h. It is more likely than not that an asset will be sold or disposed of significantly before the end of its estimated useful life.

Often, the auditor or CPA firm is also engaged to prepare the company's income tax returns. To avoid unnecessary duplication of effort between audit and tax personnel, the auditor will normally obtain the following information for additions or retirements, even though they may be immaterial to the financial statements:

a. Description of asset acquired or retired.

b. Date acquired.

c. Date of disposition.

d. Cost of asset.

e. For dispositions, amount of accumulated depreciation to date of disposition.

f. Depreciation method.

g. Life used.

h. Proceeds from disposition.

i. Gain or loss upon disposition.

WORKPAPER CONSIDERATIONS

The workpapers listed below are common when performing the property audit procedures.

a. Summary schedule of property accounts or a copy of the detailed property records.

b. A schedule to test depreciation (unless detailed property records are used).

c. Analysis of maintenance and repairs accounts, if material.

Workpapers for Property

Detailed Property Records. Depending on the assessed risks of material misstatement and audit approach selected, it may be more efficient to audit directly from the company's detailed property records. Those records normally contain the following information for each property account:

a. A description of each asset in the account.

b. The date acquired.

c. The original cost of the asset (where the total of the individual costs of all assets in the account grouping ties to the balance in the general ledger account).

d. Depreciation method.

e. Estimated useful life.

f. Accumulated depreciation at the beginning of the period.

g. Depreciation expense during the period.

h. Accumulated depreciation at the end of the period.

Property records do not have to be elaborately tested just because they are included as audit workpapers. When appropriate, the auditor might scan the additions to determine that acquisition dates are reasonable and depreciation methods are appropriate. Most errors result from data entry mistakes (i.e., an incorrect acquisition date that results in improper or no depreciation).

Summary Schedule. A summary schedule of activity in the property accounts can be used in lieu of detailed property records. If the property records are extremely long (e.g., if only paper details are available), such a schedule that includes the following columnar headings may be more efficient:

a. Prior year-end asset balance.

b. Current year asset additions.

c. Current year asset retirements and dispositions.

d. Other adjustments.

e. Current year-end asset balances before audit adjustments.

f. Audit adjustments.

g. The final adjusted asset balance.

h. Depreciation method and life.

i. Prior year-end accumulated depreciation balance.

j. Additions to accumulated depreciation for current year depreciation expense.

k. Reductions of accumulated depreciation for retirements or dispositions.

l. Current year-end accumulated depreciation balance, before adjustments.

m. Adjustments.

n. The final adjusted accumulated depreciation balance.

Test of Depreciation. If detailed property records are included in the workpapers, depreciation is normally tested by scanning the computations for reasonableness or by reperforming selected computations. Otherwise, a schedule or memo documenting an analytical test (predictive test of the current year expense) of depreciation may be used.

Repairs and Maintenance. An analysis of repairs and maintenance accounts is prepared only when the account balance totals for these accounts are material and the risks of material misstatement dictate a review of the analysis. If an analysis is needed, it ordinarily provides the following information:

a. Vendor identification.

b. Transaction reference number.

c. Description of the nature of the expenditure.

d. Date of transaction.

e. Amount.

The primary purpose of this analysis is to identify property additions that may have been improperly expensed.

Additions and Retirements. If analyses of property additions and retirements are necessary given the assessed level of risk, the following information is ordinarily obtained:

a. Description of asset.

b. Date of acquisition.

c. Transaction reference number.

d. Estimated useful life.

e. Cost.

f. Date of disposal.

g. Accumulated depreciation at disposition date.

h. Net carrying value.

i. Proceeds from disposition, if any.

j. Gain or loss, if any, from disposition.

Other Workpaper Considerations

Many times, the low risk of material misstatement generally associated with property accounts does not justify the need for detailed workpapers. A memo explaining that detailed property schedules have been scanned, depreciation tested for reasonableness, physical observations performed, inquiries made, and debt and lease documents inspected may be adequate documentation in those circumstances. However, when detail testing of significant additions, retirements, or repairs and maintenance is necessary, documentation should identify the items tested. When inquiries are made, best practices suggest that documentation include the name and title of the person queried along with date and nature of the inquiry. Also, if observations are performed, the authors recommend that documentation include what was observed, where and when the observation took place, and the names and responsibilities of any individuals that were involved in the observation.

COMMON OVER (UNDER) AUDITING TENDENCIES

Overauditing Tendencies

The primary area of overauditing in the audit of property is the performance of procedures that are clerically oriented to an extent that financial statement assertions are more than adequately supported. Some examples of those procedures are:

a. *Overtesting Depreciation Expense.* The auditor often wastes time testing the calculation of depreciation for each asset in the property records. An overall predictive or reasonableness test may be more efficient.

b. *Differences between Tax Depreciation and Book Depreciation.* In a small business, the depreciation schedules may be prepared on the basis used for income tax purposes. The auditor may spend significant time auditing the conversion of such schedules to GAAP methods. If tax and GAAP methods are not materially different, the client may not need to keep two sets of depreciation records. If there are material differences, keep GAAP records only on the significant assets, not all assets.

c. *Extensive Testing of Additions and Disposals.* An auditor who has tax return preparation responsibility may generate listings of asset additions and disposals necessary for tax computations. Including those schedules as audit documentation does not automatically require extensive audit procedures. Scanning the lists for unusual or large dollar amounts may be the only procedure necessary.

d. *Capitalization of Leases Where Difference Is Not Material.* The determination that a lease meets the criteria for a capital lease does not eliminate the auditor's judgment about the materiality of the adjustment. The time needed to determine the appropriate adjustment may not be warranted when preliminary estimates of the amounts are immaterial.

Underauditing Tendencies

Underauditing in the property section is caused primarily by the failure to recognize transactions affecting property. Examples of such underauditing tendencies are:

a. Failure to identify equipment constructed by the client, including all components of costs such as labor and overhead.

b. Failure to identify significant disposals of property or to determine if pledged assets were incorrectly sold.

c. Failure to address capitalized interest and related disclosures.

d. Lack of awareness of property additions or idle equipment during performance of other procedures, i.e., during inventory observation.

e. Failure to identify sale and leaseback transactions, especially those to related parties.

f. Failure to identify significant capital leases.

g. Failure to consider the need to recognize losses on impaired assets.

h. Failure to identify improperly capitalized costs, i.e., items that should have been immediately charged to expense.

CASE STUDY

The following case study illustrates a common issue when auditing property.

Trade-ins

The client replaced a substantial number of trucks during the year by trading in old trucks and paying an additional amount in cash. What problems does this present to the auditor?

When machinery and equipment are traded in on new equipment, and the client pays additional cash (or other boot), the GAAP and tax rules may differ. For tax purposes, no gain or loss is recognized on the exchange, and the new assets are recorded at the basis of the asset traded in, plus the amount of the boot. For book purposes, the exchange is recorded based on fair value unless it meets one of the exceptions in FASB ASC 845 allowing cost basis reporting. However, even if both book and tax record the transaction using cost basis, differences can arise if:

a. The client incurs a loss on the exchange (for example, if the fair value of the asset traded in is less than its book value).

b. The amount of boot exceeds 25% of the fair value of the exchange.

c. The client receives boot.

d. The transaction involves trading real estate.

e. The client uses different depreciation methods for tax and GAAP depreciation.

PPC's Guide to Preparing Financial Statements discusses the accounting treatment of trade-ins in detail.

RESPONDING TO FRAUD RISK

The auditor may determine that an audit response is necessary. Audit responses may be either overall or specific. Overall responses, such as assigning more experienced personnel, introducing a significant element of unpredictability, and considering the extent of supervision planned for the audit, affect the overall conduct of the audit. Auditors generally use overall responses to address fraud risks that are pervasive to the financial statements. Specific responses involve the nature, timing, and extent of auditing procedures. Specific responses are used to address fraud risks in individual audit programs, that is, at the account balance, transaction class, or financial statement assertion level.

Numerous different types of fraud schemes may be used to perpetrate either fraudulent financial reporting or misappropriation of assets. Auditors need an understanding of fraud schemes and how they are perpetrated, concealed, detected, and prevented so they can design appropriate audit responses and advise their clients about fraud prevention and detection matters. Examples of common fraud schemes related to property and procedures that may be performed in response to those schemes are provided for both misappropriation of assets (Exhibit 2-1) and fraudulent financial reporting (Exhibit 2-2). For misappropriation of assets, Exhibit 2-1 also lists the symptoms (also called red flags or indicators) auditors may observe that indicate the presence of a particular fraud scheme. For fraudulent financial reporting schemes presented in Exhibit 2-2, symptoms generally relate to fraud risk factors such as the desire to minimize reported earnings for tax-motivated reasons. Those risk factors may provide an incentive or pressure to manipulate the financial statements.

A risk of misappropriation of assets may exist in many small businesses. However, the auditor is not responsible for immaterial fraud, and many frauds involving misappropriation of assets are not material to the financial statements. Consequently, auditors need not automatically perform additional procedures related to misappropriation simply because a risk of misappropriation exists. The auditor should develop an audit response for identified risks of *material* misstatement due to fraud.

Exhibit 2-1

Common Property Fraud Schemes, Symptoms, and Related Audit Responses—Misappropriation of Assets

Fraud Scheme	Symptoms	Audit Responses[a]
Theft of property.	• Unusual or unexpected asset purchases. • Unusual or unexpected fluctuations in balance or depreciation accounts. • Unusual or unexpected changes in ancillary accounts. • Missing assets.	• Count property. • Review fully depreciated assets. • Analyze salvage and scrap sales. • Match sales of assets to reorders of replacement assets. • Review reconciliation between detail and general ledger. • Analyze capital expenditures.
Personal use of assets.	• Unusual or unexpected fluctuations in balance or depreciation accounts. • Unusual or unexpected asset purchases. • Unusual or unexpected changes in ancillary accounts. • Missing assets. • Unusual or unexpected increases in repairs and maintenance on machinery and equipment susceptible to personal use.	• Count property. • Review fully depreciated assets. • Analyze salvage and scrap sales. • Review journal entries. • Review reconciliation between detail and general ledger.

	• Personal capital improvements paid by entity. • Unusual or unexpected fluctuations in balance or depreciation accounts. • Changes in lifestyle.	• Analyze capital expenditures. • Match sales of assets to reorders of replacement assets. • Inspect capital improvements.
Manipulation of records to conceal other fraud.	• Unusual or unexpected fluctuations in balance or depreciation accounts. • Unusual or unexpected changes in ancillary accounts.	• Review journal entries. • Review reconciliation between detail and general ledger. • Count fixed assets. • Analyze capital expenditures.

Note:

[a] In addition to the specific responses listed, the auditor may also interview client personnel in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

* * *

Exhibit 2-2

Common Property Fraud Schemes and Related Audit Responses—Fraudulent Financial Reporting

Fraud Scheme	Audit Responses[a]
Recording inventory manufacturing costs, research and development costs, maintenance expenses, interest expense, start-up costs or other operating expenses as property and equipment.[b]	• Review the company's cost capitalization policy and consider whether it is similar to competitors' policies. • Scrutinize additions to property and equipment. • For self-constructed assets, inspect supporting documentation for labor allocations. • For self-constructed assets, consider whether it is appropriate to capitalize further costs (that is, if the asset is complete and available for its intended use or if the capitalized costs exceed net realizable value). • Compare capitalized costs for the period to authorized expenditures or capital budgets. • Review property and equipment detail records. • Analyze gross profit trends.
Buying personal assets for the owner/manager to own and recording them as company assets.	• Scrutinize additions to property and equipment. • Review property and equipment detail records.
Understating depreciation.	• Test depreciation calculations. • Assess propriety of depreciation methods, estimated useful lives, estimated salvage values compared to those used in prior periods. Obtain explanations and review supporting documentation for changes. • Calculate an average amortization period for the company's depreciable asset base and compare it to prior periods and benchmarks.

Not removing assets disposed of from the books.	• Perform physical inventory of property. • Review property and equipment detail records. • Inspect records for miscellaneous cash receipts and other income for evidence of proceeds from fixed asset dispositions.
Failing to write down impaired assets.	• Interview operations personnel and others who might have knowledge of indications of impairment. • Physically inspect potentially impaired assets as considered necessary.
Improperly classifying assets as held for sale to avoid future depreciation charges.	• Interview owner/manager and others who might have knowledge of (a) the current ability to remove assets from operations, (b) a formal plan of disposal, and (c) an active program to complete the plan. • Review capital replacement and other strategic plans for evidence of a plan to dispose of assets. • Review minutes of board meetings for approval of a plan of disposal.
Changing the approach used to determine write-downs to manipulate earnings.	• Review the determination of write-downs for consistency with prior periods. • Interview owner/manager about the reasons for changes in the approach used to determine write-downs.

Notes:

[a] In addition to the specific responses listed, the auditor may also interview client personnel in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

[b] Some owners/managers may record excess property and equipment to hide instances when they have overstated revenues. Therefore, when overstated property and equipment are identified, it is important to identify what account was credited as part of the transaction.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following measurement principles is used for property?

   a. Total cost of property in service should be reflected in property accounts.

   b. Depreciation is allocated based on the number of months the entity expects to own the property.

   c. Indirect costs must be excluded from property cost.

   d. All property must be stated at its fair value.

8. Match the following relevant assertion for a property audit with the correct assertion category.

   The depreciation and cost of all abandoned, damaged, sold, or obsolete property have been removed from the entity's accounts.

   a. Rights or obligations.

   b. Existence or occurrence.

   c. Cutoff.

   d. Accuracy or classification.

9. Auditors need to be aware of signs that any significant assets may be impaired. This course lists several conditions that may indicate that an asset has been impaired. Which of the following conditions applies specifically to assets that are held for sale or expected to be sold in the foreseeable future?

   a. A significant decline in the market price of the asset.

   b. A significant unfavorable change in the extent or manner of how the asset is used.

   c. A significant physical change in the asset that is adverse.

   d. Significant cost overruns beyond what was initially expected.

10. Viola, a CPA, is engaged to audit the financial statements of Middleton, Inc. This is Viola's first solo audit. Middleton had a significant amount of changes to its property accounts during the past year, as several pieces of manufacturing equipment had to be replaced or upgraded. Viola performs detail testing during the course of the property audit. How should Viola document this in the workpapers?

    a. Documentation should be made in the form of a summary memo.

    b. Name and title of the person queried should be included.

    c. Items tested should be identified in detailed workpapers.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Which of the following measurement principles is used for property? **(Page 23)**

   a. Total cost of property in service should be reflected in property accounts. [This answer is correct. Property accounts should reflect the total cost of property in service. This requires sound policies for capitalizing additions and major replacements and removing the cost of property physically returned from service or abandoned.]

   b. Depreciation is allocated based on the number of months the entity expects to own the property. [This answer is incorrect. Depreciation or depletion should be allocated over the estimated useful lives of the properties on a systematic and rational basis. Asset lives should be estimated based on the normal period of time such property should be useful for the purpose acquired.]

   c. Indirect costs must be excluded from property cost. [This answer is incorrect. Property cost may include various indirect costs, such as interest on borrowed funds, in addition to the direct cost of acquiring the asset.]

   d. All property must be stated at its fair value. [This answer is incorrect. Property should be stated at cost unless it is clear that there has been a permanent impairment in value that should be reflected in the accounts. Impaired assets should be stated at fair value.]

8. Match the following relevant assertion for a property audit with the correct assertion category. **(Page 25)**

   The depreciation and cost of all abandoned, damaged, sold, or obsolete property have been removed from the entity's accounts.

   a. Rights or obligations. [This answer is incorrect. The relevant assertion for this category related to property is that property, plant, and equipment are owned by the entity.]

   b. Existence or occurrence. [This answer is correct. A relevant assertion from this category is that property, plant, and equipment reflected in the accounts exists and is physically on hand. Another relevant assertion from this category is that the costs and related depreciation applicable to all sold, abandoned, damaged, or obsolete property have been properly removed from the accounts.]

   c. Cutoff. [This answer is incorrect. For a property audit, the relevant assertion related to cutoff that the auditor should be concerned with is that property, plant, and equipment are recorded in the proper accounting period.]

   d. Accuracy or classification. [This answer is incorrect. Another assertion that applies to this category of a property audit is that property, plant, and equipment are properly classified in the balance sheet; noncapitalizable costs are properly expensed; and capitalizable costs are excluded from maintenance or other expense accounts.]

9. Auditors need to be aware of signs that any significant assets may be impaired. This course lists several conditions that may indicate that an assets has been impaired. Which of the following conditions applies specifically to assets that are held for sale or expected to be sold in the foreseeable future? **(Page 27)**

   a. A siginificant decline in the market price of the asset. [This answer is correct. A significant decline in the market price of an asset is a condition that may indicate that an assets has been impaired. This condition also applies particularly to assets that are held for sale or expected to be sold in the foreseeable future.]

   b. A significant unfavorable change in the extent or manner of how the asset is used. [This answer is incorrect. A condition that may indicate that an asset has been impaired can occur when there is a significant adverse change in the extent or manner of the asset's use. An example of this condition is a significant decline in the use of a machine. However, according to GAAP, this condition does not particularly apply to assets that are held for sale or expected to be sold in the foreseeable future.]

   c. A significant physical change in the asset that is adverse. [This answer is incorrect. Although this condition may indicate than an asset has been impaired, it does not particularly apply to assets that are held for sale or expected to be sold in the forseeable future. An example of this condition is physical damage.]

   d. Significant cost overruns beyond what was initially expected. [This answer is incorrect. Significant cost overruns beyond the amount originally expected are a condition of impairment, but does not particularly apply to assets that are held for sale or expected to be sold in the forseeable future per GAAP.]

10. Viola, a CPA, is engaged to audit the financial statements of Middleton, Inc. This is Viola's first solo audit. Middleton had a significant amount of changes to its property accounts during the past year, as several pieces of manufacturing equipment had to be replaced or upgraded. Viola performs detail testing during the course of the property audit. How should Viola document this in the workpapers? **(Page 30)**

    a. Documentation should be made in the form of a summary memo. [This answer is incorrect. Many times, the low risk of material misstatement associated with property accounts does not justify the need for detailed workpapers. A memo explaining that detailed property schedules have been scanned, depreciation tested for reasonableness, physical observations performed, inquiries made, and debt and lease documents inspected may be adequate documentation in those circumstances. However, that is not the case based on the facts in this scenario.]

    b. Name and title of the person queried should be included. [This answer is incorrect. This documentation applies to inquiries, not the significant changes Middleton underwent in the scenario above.]

    c. Items tested should be identified in detailed workpapers. [This answer is correct. When detail testing of significant additions, retirements, or repairs and maintenance is necessary (as is the case for Viola's audit of Middleton), documentation should identify the items tested.]

Lesson 3: Other Assets

INTRODUCTION

This lesson discusses the audit procedures for several common categories of other assets—prepaid expenses, deferred charges, goodwill and intangibles, investments in securities, and derivatives. Audit procedures for these assets often are simple because the amounts are immaterial to the financial statements. However, immateriality is often overlooked, and overauditing occurs. At the other extreme, when these assets are indeed material, audit procedures tend to be inadequate to provide the auditor with sufficient appropriate audit evidence, especially for relevant assertions for investments in closely held companies. Audit procedures for long-lived assets held for sale are discussed in Lesson 2, although for financial statement purposes such assets may be reported as other current or noncurrent assets rather than property.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how to implement procedures to obtain audit evidence related to other assets.
- Identify workpaper considerations for auditing other assets, as well as commonly occurring problems, such as overauditing, underauditing, and fraud risk.

Accounting Standards

Several accounting standards are relevant to the other-asset category. Some of the more significant are summarized briefly as follows:

a. Long-term investments should be classified as noncurrent assets in the financial statements.

b. Investments in debt securities and investments in equity securities that have readily determinable fair values should be classified into one of three categories: trading, held-to-maturity, or available-for-sale. These categories are based on (1) the type of security (equity or debt) and (2) the company's ability and intent to hold the security to maturity. The category in which the investment is classified determines the carrying amount in the balance sheet and the presentation of realized and unrealized gains or losses in the income statement or statement of comprehensive income. Debt securities classified as held-to-maturity are carried at amortized cost.

c. Investments in debt and equity securities, including investments in equity securities accounted for using the cost method, are written down if they are other-than-temporarily impaired. The loss in value of an equity method investment that is other than temporary should also be recognized.

d. Financial statements of investee companies in which the investor maintains more than 50% ownership should be consolidated unless control does not rest with the majority owner. In addition, entities controlled through means other than voting interests (e.g., through variable interests) should be consolidated. However, GAAP provides an election to not consolidate certain variable interest entities. "Parent company only" financial statements may not be issued as general purpose financial statements of the primary reporting entity (but may be issued for other purposes).

e. Investments in stock of an investee representing 20% to 50% of the total voting shares outstanding are normally accounted for using the equity method. Investments representing less than 20% that do not have readily determinable fair values are normally accounted for using the cost method.

f. Derivatives generally should be measured at fair value and presented in the balance sheet as assets or liabilities. Gains or losses (i.e., changes in fair value) should be included in earnings or other comprehensive income depending on whether the derivative is designated as a hedge and, if so, the type of hedge.

g. Research and development costs (other than tangible and intangible assets acquired in a business combination that are used for research and development activities) should be charged to expense when incurred.

h. Intangible assets should be initially recognized and measured based on their fair value. An intangible asset with a finite useful life should be amortized; an intangible asset with an indefinite useful life should not be amortized. Costs of developing, maintaining, or restoring intangible assets that are not specifically identifiable, that have indeterminate lives, or that are inherent in the activities of a continuing business should be expensed when incurred.

i. Business combinations (i.e., transactions or other events in which an acquirer obtains control of one or more businesses) should be accounted for under the *acquisition method* of accounting. Under that method, the acquirer recognizes and measures at fair value the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree as of the acquisition date, although an accounting alternative may be available for some identifiable intangible assets.

j. Goodwill acquired in a business combination may be amortized. FASB ASC 350-20-35-65 through 35-82 provides a simplified accounting alternative for goodwill by allowing nonpublic entities to elect to amortize goodwill on a straight-line basis over 10 years or less than 10 years if the entity determines that a shorter period is more appropriate. Impairment testing is only required when a triggering event has occurred that indicates that the fair value of the entity or reporting unit may be below its carrying amount. Goodwill and other intangible assets not subject to amortization should be tested for impairment annually, or more frequently if circumstances warrant.

k. Costs of start-up activities, including organization costs, should be expensed as incurred.

l. A barter credit asset should be recorded at the fair value of the nonmonetary asset exchanged. Fair value should not be based on an estimate of the value of the barter credits to be received. Subsequently, an impairment loss should be recognized if the fair value of remaining barter credits is less than the carrying amount or if it is probable that all of the remaining barter credits will not be used.

m. Several of the other assets discussed in this lesson may be presented at fair value. Measurement and disclosure requirements are established by FASB ASC 820-10 for situations in which other FASB ASC sections require or permit fair value measurements or disclosures.

More information on the accounting requirements and guidance pertinent to auditing other assets is provided in the sections of this chapter in which each of those other-asset categories is discussed. Recent FASB ASUs with future effective dates that modify or supplement current GAAP are also explained briefly at relevant points in the chapter. A more detailed discussion of the accounting standards applicable to accounting for other assets is provided by *PPC's Guide to Preparing Financial Statements* and *PPC's Guide to GAAP*.

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

According to AU-C 500.06, *Audit Evidence*, appropriate audit procedures should be designed and performed to obtain sufficient appropriate audit evidence. AU-C 500.A10 states that those audit procedures consist of risk assessment procedures, tests of controls, and substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor's opinion, but do not, by themselves, provide sufficient appropriate audit evidence. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, at AU-C 330.18, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The auditor uses relevant assertions in

assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions, or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

Relevant Assertions for Other Assets

The relevant assertions for prepaids, investments, and other assets generally are as follows:

	Prepaids, Deferred Charges, Goodwill, Intangibles, and Similar Assets	**Investments and Derivatives**
Existence or occurrence (E/O)	Prepaids and other assets reflected in the accounts exist.	Investments and derivatives reflected in the accounts exist.
Completeness (C)	Prepaids and other assets reflected in the accounts represent a complete listing of the company's costs that are allocable to future periods. Disclosures required by GAAP have been made.	Investments and derivatives reflected in the accounts represent a complete listing of all investments and derivatives. All entities that, under GAAP, should be consolidated have been included in the consolidated financial statements. Disclosures required by GAAP have been made.
Rights or obligations (R/O)	Prepaids and other assets reflected in the accounts are the assets of the entity.	The entity's ownership of investments and derivatives is evidenced by securities or other appropriate legal documents either physically on hand or held in safekeeping by others.
Valuation or allocation (V)	Prepaids and other assets can reasonably be expected to be realized through future operations and are properly amortized or written off on an acceptable basis consistent with methods used in prior periods; impairment of balances is recognized by write-downs.	Investments and derivatives are appropriately valued at cost or fair value in accordance with GAAP. Impairment of investments is recognized by write-downs.
Cutoff (CO)	Prepaids and other assets and any related amortization or write-downs are recorded in the proper accounting period.	Assets, investment income or loss, valuation allowances, gains or losses, and changes in fair value are recorded in the proper accounting period.
Accuracy or classification (A/CL)	Prepaids and other assets and any related amortization or write-downs are properly described and classified. Prepaids and other assets and any related amortization or write-downs are recorded in the proper accounts at appropriate amounts. Information about prepaids and other assets, including restrictions, pledges, or liens against other assets, is disclosed fairly at appropriate amounts.	Investments are properly identified and classified. Assets, investment income or loss, valuation allowances, gains or losses, and changes in fair value are recorded in the proper accounts at appropriate amounts. Information about investments and derivatives, including any restrictions, pledges, or liens against the assets, is disclosed fairly at appropriate amounts.

Substantive Audit Procedures for Prepaids, Investments, and Other Assets

For many entities, balances for prepaids, investments, and other assets are immaterial. Accordingly, substantive audit procedures generally consist of a combination of inquiry and analytical procedures. If balances are material, substantive procedures may also include vouching (for example, vouching activity during the year and comparing market values to quoted prices), confirmation, and inspection. Examples of inquiry and analytical procedures at the account balance level for prepaids, investments, and other assets are as follows:

- Scan the activity during the year in the prepaids, investments, and other asset accounts; compare current asset and expense balances to those of the prior year or other auditor-developed expectations; and investigate unusual items. (E/O, C, V, A/CL, CO)

- Consider the proper financial statement descriptions and balance sheet classification between current and noncurrent assets. For securities, obtain an understanding of management's process for classifying securities as trading, available-for-sale, or held-to-maturity; determine that securities are appropriately valued, and that realized and unrealized gains and losses are properly classified in equity or the income statement. (V, A/CL)

- Evaluate the reasonableness of carrying amounts and unamortized balances. Consider whether knowledge of the client and its business and industry indicate an impairment that requires a writedown or a change in useful life. (V)

- Inquire about pledged assets, liens, or restrictions on the assets and relate to audit procedures in other areas (for example, bank and debt confirmations and review of minutes and debt agreements). Summarize information for financial statement disclosure. (R/O, A/CL)

Prepaids

Rarely are prepaid expenses material to the financial statements of any size entity. Audit tests normally can be limited to scanning and analytical procedures, or audit tests can be applied only to material balances, for example, significant insurance premiums or deposits. Avoid the temptation to prepare elaborate analysis schedules when the balances are not material. One common analytical review procedure is comparison of current year and prior year account balances. Often, the auditor's preliminary and final analytical procedures, along with the auditor's risk assessment procedures, provide sufficient audit evidence about immaterial prepaids.

Many auditors test prepaid insurance regardless of the size of the balance to evaluate a company's insurance coverage. However, testing the adequacy of a company's insurance does not relate to any of the financial statement assertions, nor does accounting literature require disclosure of the adequacy of insurance. Best practices suggest reviewing insurance coverage as a client service only when there is an obvious high risk of loss, e.g., inventory is stored in a warehouse with high theft or fire risk or flammable products are stored by the company.

Cash Surrender Value of Life Insurance

Cash surrender values normally are immaterial, but the auditor might feel obligated to confirm those balances as a client service. Generally, reviewing the reasonableness of the major cash surrender values is sufficient. When balances are confirmed, consider confirming them a month prior to the balance sheet date, e.g., confirm the balance as of 11-30-X2 for a 12-31-X2 audit. The client can adjust the books before year end based on the confirmation. The resulting balance will be incorrect by one month, but that ought to be immaterial. This procedure will eliminate delays in receiving the confirmation letter and reduce the number of adjusting entries processed through the audit.

Investments in Debt and Equity Securities

Businesses outside the financial services industry often do not engage in significant investment activities. Accordingly, balances are usually immaterial, or the portfolio of securities has only a few items. Tests in those circumstances are relatively simple. If the entity has large portfolios of securities, the audit procedures and accounting standards can be complex.

Key considerations when auditing investments in debt and equity securities include evaluating whether securities are properly classified as trading, available-for-sale, or held-to-maturity, whether they are properly valued at fair value or amortized cost, and the proper treatment of unrealized gains or losses. Evaluating impairment is discussed later in this lesson.

In addition, investment portfolios may sometimes be held by a custodian, such as a broker/dealer or bank trust department. In some cases (depending on the nature of transactions processed by the custodian and the other functions performed by the custodian), the auditor may need to consider obtaining a service auditor's report on the custodian's internal controls to gain an understanding of controls sufficient to assess the risks of material misstatement and design further audit procedures. For example, confirmation is generally sufficient if custody services are provided by a regulated, financially sound custodian that does not perform other functions, and the investments do not comprise substantially all of the entity's assets. While confirmation with the custodian is generally sufficient to test the existence assertion, confirmation with the custodian or other third party is not by itself adequate audit evidence for the valuation assertion. However, if the custodian has discretionary trading authority, all of the information available to the entity and the auditor concerning trading and investments held is controlled by the custodian-advisor. In that case, the auditor cannot reduce the risks of material misstatement to an appropriate level without obtaining persuasive evidence of the effectiveness of the custodian-advisor's controls, such as by obtaining a type 2 service auditor's report, or direct evidence of the existence of investments or occurrence of trading, such as by direct communication with the subcustodian or clearing agency.

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, provides requirements and application guidance for certain aspects of auditing the valuation of investments in debt and equity securities measured at fair value. Specifically, AU-C 501.06–.09 require the auditor to—

- determine if GAAP specifies a method for measuring fair value,
- evaluate whether fair value is measured in accordance with that method,
- for fair value based on a valuation model, test management's determination of fair value, or if applicable, understand the method used by a broker-dealer or other third party to determine fair value and consider the guidance for use of a management's specialist, and
- evaluate management's conclusion about the need for an impairment loss and test any impairment adjustment, including compliance with GAAP.

Specific requirements related to auditing fair value accounting estimates can be found in AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. AU-C 501 specifically notes that more detailed guidance on planning and performing auditing procedures on investments in securities can be found in an AICPA Audit Guide. The AICPA Audit Guide, *Special Considerations in Auditing Financial Instruments*, provides interpretive guidance for auditing financial instruments, including investments and derivatives. The Audit Guide includes suggested procedures to clarify and illustrate the application of auditing standards. The Audit Guide is available at **www.aicpastore.com** or on Checkpoint by calling Thomson Reuters at (800) 431-9025 or visiting the website at **tax.thomsonreuters.com**.

Investments Accounted for Using the Cost, Equity, or Consolidation Methods

There is a tendency to overaudit most categories of other assets, but the opposite is true of investments in closely held companies. It is not uncommon to have a material investment or ownership interest in another corporation, partnership, or joint venture. Underauditing can occur because (a) the auditor does not realize that the financial statements of the investee should be subjected to audit procedures and (b) accounting methods selected to record the investment may be incorrect.

Audit Requirements. AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, provides requirements and application guidance for auditing investments accounted for using the equity or consolidation methods. AU-C 600 applies to audits of all types of financial statements that aggregate financial information of equity method investees, subsidiaries, joint ventures, variable interest entities, and other components. AU-C 600 specifies the types of procedures that need to be applied to the financial

information of a component depending on its materiality and risk characteristics, which may be an audit of financial information; audit of specific elements, accounts, or items of a financial statement; specified audit procedures; a review; or analytical procedures. Under that guidance, an equity method investee or consolidated entity that is material should be audited. Thus, audit evidence would include audited financial information of the investee. The audit work may be performed by the auditor of the consolidated financial statements or by another auditor on his or her behalf. AU-C 600 also provides guidance on matters such as determining whether to make reference to component auditors, determining materiality for components, communications with component auditors, and additional responsibilities when assuming responsibility for the work of component auditors.

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, provides requirements and application guidance for certain aspects of auditing the valuation of investments in securities when valuations are based on the investee's financial results. The requirements and application guidance do not apply to equity method investments; AU-C 600, as discussed in the preceding paragraph, applies to those investments. Specifically, AU-C 501.04–.05 require the auditor to—

- obtain and read available financial statements of the investee and the accompanying auditor's report and determine whether the report is satisfactory for the auditor's purpose,
- if the investee's financial statements are not audited, or if the auditor's report is unsatisfactory, apply, or arrange for another auditor to apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment,
- if the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, obtain sufficient appropriate audit evidence to support those amounts,
- if a difference between the financial statement period of the entity and the investee could have a material effect on the entity's financial statements, determine whether the lack of comparability has been appropriately considered and the effect, if any, on the auditor's report, and
- obtain and read available interim financial statements of the investee and inquire of investor management to identify subsequent events and transactions, occurring after the date of the investee's financial statements but before the date of the auditor's report, that may be material to the investor's financial statements and need to be recognized or disclosed in the investor's financial statements.

The auditor also needs to be aware that a report modification (an *except for* qualification, going concern uncertainty, or disclaimer) on the investee's financial statements, if material, could carry through to the report on the investor's financial statements. In addition, the auditor also performs procedures to ensure that material transactions between the company and the investee are identified and properly disclosed and the company's share of any unrealized intercompany profit or loss is properly eliminated. Investments also should be reviewed for impairment.

Accounting Methods. The accounting method that is appropriate for an investment in a closely held company depends on the investor's ownership interest and degree of influence over the operations of the investee. There are three basic accounting methods:

a. *Cost Method.* Under the cost method, an investor records an investment in common stock of an investee at cost. The investor generally recognizes revenue only when dividends are received. Changes in the financial position of the investee are not recognized by the investor unless the changes represent an other-than-temporary decline in the value of the investment. Generally, investments of less than 20% of the outstanding voting stock of an investee are accounted for by the cost method. (FASB ASC 320 requires investments in equity securities with *readily determinable* fair values to be accounted for at fair value. Those investments are discussed earlier in this lesson.)

b. *Equity Method.* Under the equity method, an investor initially records an investment in common stock of an investee at cost and records its proportionate share of changes in the net assets of the investee as an adjustment of the carrying value of the investment. Generally, investments of 20% to 50% of the outstanding voting stock of an investee are accounted for by the equity method. However, an entity might be able to choose the fair value option in FASB ASC 825-10 for investments that would otherwise be accounted for by the equity method.

c. *Consolidation Method.* Under the consolidation method, the financial statements of the investee are combined with those of the investor and intercompany amounts are eliminated. The consolidation method differs from the equity method only in form; both methods result in the same income and equity for the investor. The equity method is sometimes referred to as a "one-line" consolidation. The consolidation method is required when the investor owns more than 50% of the voting stock of the investee, unless control does not rest with the majority owner. In addition, entities controlled through means other than voting interests (e.g., through variable interests) generally must be consolidated.

Accounting for VIEs. A related area of concern is the appropriate consolidation of entities commonly referred to as variable interest entities. Such entities are often created to carry out a specified purpose or activity. In a variable interest entity (VIE), control is achieved through variable interests rather than through voting interests. Accounting guidance for VIEs is found in FASB ASC 810, *Consolidation*. FASB ASC 810 generally requires consolidation of entities that are controlled through variable interests. Detailed guidance on accounting for VIEs can be found in *PPC's Guide to Related Parties (Including Variable Interest Entities)*, *PPC's Guide to GAAP*, and *PPC's Guide to Preparing Financial Statements*.

FASB ASC 810-10-15-17AA through 17C provides an accounting alternative to nonpublic companies to forego the application of the VIE guidance for certain lessor entities. The accounting alternative is available when (a) the reporting entity is a lessee that has a lease agreement with a lessor and both entities are under common control, (b) substantially all of the activities between the two entities relate to the lease, and (c) if the reporting entity provides collateral for or explicitly guarantees an obligation of the lessor that relates to the leased asset, the obligation's principal amount at the inception of the guarantee or collateral arrangement does not exceed the value of the leased asset. If elected, the accounting alternative should be applied retrospectively to all presented periods.

Auditing VIEs. Except as noted below, auditors need to be alert for the existence of variable interest entities. Auditors may consider the following broad steps when addressing variable interest entities:

a. Identify the population of VIEs.

b. Consider the involvement of related parties.

c. Identify VIEs in which the client is the primary beneficiary.

d. Determine if the VIE has been properly accounted for in the consolidated financial statements when the client is the primary beneficiary.

e. For VIEs where the client is not the primary beneficiary, determine if the client has accounted for its interests in accordance with GAAP.

f. Consider if additional evidence is needed.

g. Consider the appropriateness of disclosures for VIEs in which the client is involved.

h. Obtain appropriate representations from management.

i. Consider whether, as a result of the auditor's procedures, an audit report modification (e.g., scope limitation) is needed.

Best practices indicate that procedures performed to determine whether a small or midsize nonpublic entity has identified all related party relationships and transactions, will ordinarily be sufficient to determine whether it has identified all interests in other entities that might require consolidation under the variable interest entities guidance in FASB ASC 810. If there are interests in entities that might require consolidation, procedures ordinarily will include reviewing operating agreements and making inquiries of management and others to determine whether the company has properly identified which entity controls the VIE. Procedures to test the consolidation of VIEs are generally the same as procedures to test the consolidation of entities that are controlled through ownership of a majority voting interest.

Equity Method

When investments are accounted for using the equity method as described earlier, several accounting or auditing issues often arise in practice as discussed in the following paragraphs.

Deferred Taxes. When investments are accounted for under the equity method, often a difference results between the book and tax basis of the asset. Accordingly, the auditor needs to be especially aware of the need to evaluate whether a deferred tax asset or liability has been properly recognized.

Basis of Accounting. A common oversight in applying consolidation or equity accounting to an investment in another company is failing to determine if the investor and the investee are on the same basis of accounting. If the financial statements of the investor are on the accrual basis, the financial statements of the investee should also be on the accrual basis. If the basis of accounting of the investee is not converted to agree with the investor's before applying consolidation or equity accounting, and the auditor believes the effect is material, the auditor's report should be qualified for a GAAP departure. However, if the investee operates in a specialized industry that follows a specialized basis of accounting, that basis of accounting is retained in the financial statements of the investor, and there is no GAAP departure. For example, if the investee is an investment company or broker/dealer in securities that uses a fair value basis of accounting, that basis of accounting should not be changed for purposes of consolidation or equity accounting even though the investor's basis of accounting differs. When a component's financial statements are prepared using a different financial reporting framework than that used for the group financial statements, making reference to the component auditor in the group auditor's report on the group financial statements is appropriate if (a) the financial reporting frameworks are similar, and (b) the group auditor takes responsibility for auditing the conversion adjustments.

Date of the Investee's Financial Statements. An often-asked question is whether the date of the results of operations of the investor must coincide with the date of the results of operations of the investee. For example, if the financial statements of the investor are dated December 31, 20X1, must the equity in earnings of the investee also be recorded through December 31, 20X1? FASB ASC 810-10-45-12 indicates that if the difference is not more than about three months, it usually is acceptable to use the investee's statements for its fiscal period. When this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations of the investor. FASB ASC 810-10-45-13 and 810-10-50-2 requires a parent or investor to report a change to or the elimination of an existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee as a change in accounting principle.

Losses That Exceed the Original Investment. The investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method. The investor normally should discontinue applying the equity method when the investment is reduced to zero. However, FASB ASC 323-10-35-20 states that if the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support, losses should continue to be recorded by the investor to the extent of additional funds committed. An investment that has been reduced below zero should be presented as a liability in the balance sheet of the investor.

Differences between Cost and Underlying Equity in Net Assets of Investee. There may be a difference between the cost of an investment and the investor's proportionate equity in the investee's net assets at acquisition. The investor assigns the difference to specific assets of the investee based on their fair values, with any remainder attributable to goodwill. (FASB ASC 323-10-35-13) The investor subsequently records additional depreciation or amortization related to the difference as if it were actually recorded by the investee. (As a practical matter, however, unless the difference is material, it usually is accounted for as goodwill following the provisions of FASB ASC 350-20.) If the carrying amount of the investment in the investor's financial statements reflects factors that are not recognized in the investee's financial statements, auditors need to obtain sufficient appropriate audit evidence to support those amounts.

Business Combinations

A nonpublic company might acquire another business. In most cases, accounting for the transaction is relatively straightforward. The acquirer issues cash or debt in exchange for assets and liabilities of another business that are contractually identified. However, some business combinations present challenges for the acquiring entity, along

with heightened risks of material misstatement, the auditor will need to carefully assess when planning the engagement. Some of the key challenges and risks include:

- *Identification of Assets Acquired and Liabilities Assumed.* A business combination may not contractually identify all individual assets acquired and liabilities assumed. Furthermore, the acquiring business may need to recognize assets and liabilities that were not previously recognized by the acquiree.

- *Measurement of Assets Acquired, Liabilities Assumed, and Noncontrolling Interest in the Acquiree.* Most assets acquired and liabilities assumed in a business combination are measured at fair value. Any noncontrolling interests in the acquiree must also be measured at fair value. In some cases, quoted prices in an active market may not be available for the determination of fair value. As a result, other valuation techniques may need to be employed and may require unobservable inputs as discussed in FASB ASC 820-10.

- *Recognition and Measurement of Goodwill.* The proper recognition and measurement of goodwill recognized in a business combination is dependent upon the proper identification and recognition of (a) identifiable assets acquired and liabilities assumed, including the recognition and measurement of deferred income tax assets and liabilities under FASB ASC 740; (b) the consideration transferred; and (c) any noncontrolling interest in the acquiree. As a result, a misstatement in any of these variables will result in a misstatement in the determination of goodwill.

Accounting Requirements. The guidance in FASB ASC 805, *Business Combinations*, indicates that business combinations should be accounted for using the *acquisition method*. The acquisition method requires the following:

a. Identifying the acquirer.

b. Determining the acquisition date.

c. Recognizing and measuring:

   (1) Identifiable assets acquired, liabilities assumed, and noncontrolling interests.

   (2) Goodwill or a gain from a bargain purchase.

Identifiable assets acquired, liabilities assumed, and noncontrolling interests should be measured at fair value as of the acquisition date. Goodwill is recognized at the acquisition date and is measured as the excess of (a) over (b) as follows:

a. The aggregate of the (1) consideration transferred, (2) fair value of any noncontrolling interest in the acquiree, and (3) acquisition-date fair value of any previously held equity interest in the acquiree, if the business combination was achieved in stages.

b. Net amount of identifiable assets acquired and liabilities assumed as of the acquisition date.

FASB ASC 805 provides an accounting alternative to simplify accounting for certain identifiable intangible assets acquired in business combinations by nonpublic entities. A nonpublic entity may elect to not recognize or otherwise consider the fair value of intangible assets as a result of any business combinations should no longer recognize separately from goodwill (a) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (b) noncompete agreements. Entities electing this accounting treatment would generally recognize fewer identifiable intangible assets than under current GAAP. An entity that makes this election must also elect the private company alternative to amortize goodwill as described in FASB ASC 350-20-35-62.

FASB ASC 805-50-25-4 through 805-50-25-9 addresses whether and when a new accounting and reporting basis arising from an acquisition would be reflected in an acquiree's separate financial statements. This is commonly referred to as pushdown accounting. The guidance allows an acquired entity to elect to apply pushdown accounting to its separate financial statements on the occurrence of an event that results in the acquirer obtaining

control of the entity. An acquired entity can elect to apply the guidance to future change-in-control events or to its most recent event that is a change-in-control. The application of this guidance is a change in accounting principle if the financial statements for the period in which the most recent change-in-control event occurred have already been issued or are available to be issued. Many of the audit procedures discussed later may be appropriate to apply when auditing an acquiree that elects to apply pushdown accounting and issue separate financial statements.

Audit Considerations. The following procedures are normally applied when material business combinations have occurred:

a. Obtain and read copies of the purchase, merger, or other similar agreements. Include in the current or permanent workpaper files abstracts or copies of the agreements.

b. Examine the support for identified assets acquired (including identifiable intangible assets the entity elects to recognize), liabilities assumed, and noncontrolling interests in the acquiree.

c. Examine the support and determine the reasonableness of the acquisition date fair values of identifiable assets acquired (including identifiable intangible assets), liabilities assumed, and noncontrolling interests in the acquiree.

d. Examine the support and determine the reasonableness of the acquisition date fair value of the consideration transferred.

e. Review the calculations and determine the reasonableness of amounts assigned to deferred taxes and goodwill.

f. If applicable, review supporting documentation for adjustments to provisional amounts during the measurement period.

Derivatives

FASB ASC 815, *Derivatives and Hedging*, requires all entities to measure derivatives at fair value and recognize them as either assets or liabilities in the balance sheet. Explaining all of the complex accounting requirements related to derivatives is beyond the scope of this course. A brief overview follows.

What Is a Derivative? A *derivative* is a financial instrument or other contract with all three of the following characteristics:

a. It has at least one underlying (such as an interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable, including the occurrence or nonoccurrence of a specified event) and at least one notional amount (such as a specified number of currency units, shares, bushels, pounds, or other units) or payment provision (such as a fixed or determinable settlement to be made if the underlying performs in a specified manner) or both.

b. It requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors.

c. Its terms require or allow net settlement, it can readily be settled net by a method outside the contract, or it provides for delivery of an asset that puts the recipient in a position similar to net settlement.

A derivative may be a stand-alone contract or it may be embedded in another contract, such as a loan agreement, bond, insurance contract, or lease agreement. In some cases, an embedded derivative should be accounted for separately from the host contract. An issuer of a loan commitment related to the origination of a mortgage loan to be held for sale must account for the loan commitment as a derivative instrument.

Accounting for Derivatives. FASB ASC 815 requires derivatives to be measured at fair value and reported in the balance sheet as assets or liabilities. Accounting for gains and losses (that is, changes in fair value) depends on the

intended use of the derivative. Gains and losses on derivatives not designated as hedging instruments should be recognized in earnings in the period of the change in fair value. For example, an investment in a speculative option to buy units of foreign currency should be reported as an asset and adjusted to its fair value, with changes in fair value included in net income. Accounting for gains and losses on hedging instruments depends on the type of hedge, as follows:

a. *Fair Value Hedge.* If the derivative is intended to hedge the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, the gain or loss on both the derivative and the hedged item generally should be included in earnings in the period of the change. This treatment is also applicable to a derivative designated as a hedge of a foreign currency exposure of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security).

b. *Cash Flow Hedge.* If the derivative is intended to hedge the exposure to variable cash flows of a forecasted transaction, the gain or loss on the hedge generally should be included as a component of other comprehensive income until the forecasted transaction affects earnings. A hedge of a foreign currency exposure of a foreign-currency-denominated forecasted transaction should also be treated as a cash flow hedge.

c. *Foreign Currency Hedge.* If the derivative is intended to hedge the foreign currency exposure of a net investment in a foreign operation, the gain or loss in fair value should be reported in other comprehensive income as part of the cumulative translation adjustment.

FASB ASC 815 establishes detailed rules for determining whether a derivative qualifies for hedge accounting and also establishes specific documentation requirements for derivatives designated as hedging instruments.

Common Uses of Derivatives. Derivatives offer a way for small and medium-sized entities to manage their exposure to risks and to speculate on changes in market conditions. Common derivatives, often referred to as *plain vanilla* derivatives, are available through banks and other sources. The following paragraphs explain the use of an interest rate swap. Other uses of derivatives, such as options to establish a range of interest rates, the use of forward contracts, and options to buy foreign currency, are explained in *PPC's Guide to Preparing Financial Statements*.

Interest Rate Swap. An interest rate swap is a derivative that may be used to convert a variable interest rate to a fixed rate or vice versa. To illustrate, assume that an entity has a $100,000 note that is payable to a bank in three years and bears interest annually at a rate equal to the U.S. Treasury rate plus 3%. To help stabilize cash flow requirements, the entity wants to fix its interest payments at 8%. It therefore enters into an interest rate swap contract with the bank under which the entity makes a small up-front payment and annually writes or receives a check equal to the difference between interest on $100,000 at a fixed rate of 8% and at the Treasury rate plus 3%. The swap has each of the characteristics required for a derivative—

a. It has an interest rate underlying, and its notional amount is the $100,000 base on which interest receipts and payments are calculated.

b. It requires a small initial net investment.

c. Net settlement is permitted by only receiving or paying cash for the effect of the difference between the two interest rates.

To illustrate how the swap operates, assume that shortly after the note was issued, the Treasury rate rose to 7% and that during the first year the note was outstanding, the variable rate was 10% (which equals the 7% Treasury rate plus 3%). For the first interest payment—

- The entity owes the bank $10,000 for interest on the note (which is the product of the $100,000 principal balance and the 10% variable interest rate).

- Under the swap, the entity owes the bank $8,000 (which is the product of the $100,000 principal balance and the 8% fixed rate), and the bank owes the entity $10,000 (which is the product of principal and the

variable interest rate). The entity therefore receives a $2,000 payment from the bank for the excess of the $10,000 due from the bank over the $8,000 due to the bank.

The entity records interest expense of $8,000 for the excess of the $10,000 paid under the variable rate provision over the net $2,000 received under the swap agreement. That equals interest on the $100,000 principal balance at the 8% fixed rate the entity desired.

FASB ASC 815-10-35-1A thru 53-1C provides a simplified hedge accounting approach for private companies that enter into certain plain vanilla interest rate swaps solely to convert variable rate debt to a fixed rate. For interest rate swaps that meet the criteria, the entity can assume that there is no ineffectiveness in the hedging relationship. Under the simplified hedge accounting approach, an entity is allowed the option to measure these swaps at settlement value rather than fair value, and the hedge documentation is allowed to be completed up to the date that the financial statements are available to be issued. The provisions of this guidance are discussed further in *PPC's Guide to Preparing Financial Statements*.

Auditing Considerations. Most small and midsize businesses (other than companies in the financial services industry, companies that conduct business with foreign entities, or companies in industries where commodity contracts are common) have few derivative instruments. However, when they are material, derivatives present unique auditing considerations due to the complex nature of derivative transactions and the accounting requirements that apply to them. As part of the risk assessment process, auditors obtain an understanding about aspects of the company's operations that might present risks hedged using derivatives and inquire about the extent of derivative use, the types of derivatives used, the entity's purpose in using derivatives, and the entity's controls over derivatives transactions. Auditing procedures need to be tailored for the type of use and related risks.

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, provides requirements and application guidance for certain aspects of auditing the valuation of derivative instruments. Specifically, AU-C 501.06–.08 and AU-C 501.10 require the auditor to—

- determine if GAAP specifies a method for measuring fair value,
- evaluate whether fair value is measured in accordance with that method,
- for fair value based on a valuation model, test management's determination of fair value, or if applicable, understand the method used by a broker-dealer or other third party to determine fair value and consider the guidance for use of a management's specialist, and
- test the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized or disclosed because of the ineffectiveness of a hedge, including evaluating compliance with GAAP.

Specific requirements related to auditing fair value accounting estimates can be found in AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. AU-C 501 specifically notes that more detailed guidance on planning and performing auditing procedures on derivative instruments can be found in the AICPA Audit Guide, *Special Considerations in Auditing Financial Instruments*, (The Audit Guide), which provides interpretive guidance for auditing financial instruments, including investments and derivatives. The Audit Guide includes suggested procedures to clarify and illustrate the application of auditing standards and case studies covering various types of derivatives, such as swaps, options, and foreign currency put options, as well as embedded derivatives. The Audit Guide is available online at **www.aicpastore.com** or on Checkpoint by calling Thomson Reuters at (800) 431-9025 or visiting the website at **tax.thomsonreuters.com**. Auditors may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives.

Key considerations when auditing derivatives include identifying derivative instruments, including those that are embedded; evaluating whether derivative instruments are properly designated as hedging instruments and, if so, the type of hedge; evaluating whether derivative instruments are properly valued at fair value; and assessing the proper treatment of changes in fair value. For derivatives designated as a hedge, the auditor is also concerned with whether the entity has assessed the effectiveness of the hedging relationship at inception and when financial statements are prepared (or at least every three months). In addition, if the derivative has been designated as a fair value hedge, the auditor determines that the changes in fair value of the hedged item are properly accounted for.

For cash flow hedges of forecasted transactions, the auditor evaluates management's determination about whether the forecasted transaction is probable of occurring. The auditor ordinarily needs to obtain written representations from management about its intent and ability to enter into a forecasted transaction for which hedge accounting has been applied. In addition, the auditor considers obtaining representations about other aspects of derivatives that affect assertions in the financial statements.

The first step in auditing derivatives is to test completeness (whether all derivative instruments have been identified by the client and recorded in the financial statements). Because derivatives may not involve an initial net investment, when designing tests for completeness, auditors cannot focus exclusively on evidence relating to cash receipts and disbursements. In more sophisticated organizations, it may be difficult to limit detection risk for assertions about the completeness of derivatives to an acceptable level without performing tests of controls. Accordingly, the auditor may need to test controls either at the client or at a service organization. Common procedures performed to identify derivative instruments (that is, to test for completeness) include:

a. Inquiring of management or the owner/manager to determine if the entity has entered into any contracts that meet the definition of a derivative.

b. Inspecting agreements (such as loan agreements, leases, insurance contracts, purchase contracts, etc.) to identify embedded derivatives and determine whether they are accounted for properly.

c. Requesting information from the counterparty to financial instrument contracts.

d. Confirming the existence of derivatives with counterparties who are frequently used, but with whom the accounting records indicate there are currently no derivatives.

e. Performing analytical procedures. For example, an analytical test of interest expense may identify the existence of an interest rate swap.

f. Inspecting documentation for activity after year end that may indicate the existence of derivatives at year end.

g. Reading other information such as the minutes of board of directors' or investment committee meetings for approval of derivative transactions.

If the company holds derivative financial instruments, the auditor may consider confirming significant terms with the counterparty to the contract or executing broker. Auditors may also consider confirming with counterparties or executing brokers the derivatives activity during the year. Activity may be scanned and compared with the description of the entity's use of derivatives provided by the client to validate the client's description. In addition, if the derivative instrument has been designated as a hedge, the auditor may inspect management's documentation of the hedging relationship to determine that the derivative qualifies for hedge accounting. To qualify for hedge accounting, the entity has to comply with specific documentation requirements *at the inception of the hedge*. However, there is an exception for private companies that enter into certain plain vanilla interest rate swaps solely to convert variable rate debt to a fixed rate. Hedge documentation may be completed up to the date that the financial statements are available may be issued. Therefore, it is important for the auditor to verify the timeliness of the documentation of the hedging relationship.

The fair value of derivatives may be based on quoted market prices, fair value estimates from broker-dealers or other third-party sources, or determined by the entity using a valuation model. If the fair value estimates are obtained from broker-dealers or other third-party sources based on valuation models, the auditor needs to obtain an understanding of the method they used to develop the estimates and consider the relevance and reliability of the information to be used as audit evidence. In addition, the auditor needs to consider the guidance on using the work of specialists when using their work as audit evidence. If the fair value estimates are determined by the client using a valuation model, the auditor performs procedures to obtain sufficient audit evidence to support management's assertions about fair value. Procedures the auditor may perform to assess the reasonableness of the client's fair value estimate include:

a. Assessing the reasonableness and appropriateness of the client's model. For example, the auditor determines whether the market variables and other assumptions used by the client are reasonable.

b. Calculating the fair value using a model developed by the auditor or a specialist as an independent expectation to corroborate the reasonableness of the client's valuation.

c. Testing the operating effectiveness of controls over how management estimated the fair value and performing substantive procedures.

d. Comparing the fair value with the exchange price for recent or subsequent transactions.

As a practical matter, it seems likely that small and midsize entities can obtain estimates of the fair value of most of their derivatives from banks and broker-dealers. Otherwise, the entity can use a variety of estimation techniques to estimate the fair value of derivatives; for example:

a. Nonexchange-traded stock options can be valued using the Black-Scholes model. Templates are available through the Internet that will calculate an option's fair value by applying the Black-Scholes model to information entered by the accountant. The templates can be found using the major Internet search engines, for example, by searching on "Black-Scholes." Some sites are free-of-charge, and others charge only a nominal fee. In addition, computer spreadsheets can be designed to perform Black-Scholes calculations.

b. Discounted cash flows can be used to estimate the fair value of a variety of common derivatives, such as swaps and forward contracts. As examples:

   (1) The fair value of an interest rate swap can be estimated by discounting estimated cash flows using both the pay and receive rates; the zero-coupon method is one such technique.

   (2) The fair value of a foreign currency forward contract can be estimated by discounting estimated purchases and sales of foreign currency using the forward rate.

   Computer spreadsheets are helpful tools in performing such calculations.

If quoted market prices are obtained from broker-dealers who are market makers for certain derivatives, special knowledge may be needed to understand the circumstances in which the quote was developed. For example, those quotes may only be an indication of interest rather than an actual price at which a counterparty would purchase or sell the underlying derivative.

Barter Credits

A company might exchange a nonmonetary asset, such as inventory, for barter credits that can be used to purchase goods or services, such as advertising time. The transaction might be facilitated by a barter company that arranges transactions among principals, or might be directly between principals. The arrangement might require the payment of cash in addition to the barter credits to receive the goods or services. The barter credit would often be classified as a prepaid, deferred charge, or other asset. Risks of material misstatement related to such transactions include the risk that management might be exchanging excess, slow-moving, or obsolete inventory for an advertising credit of dubious utility to avoid recognizing a loss on inventory.

Accounting Considerations. Because the asset acquired in a barter transaction may be recorded at the fair value of the asset given in exchange, or the asset acquired, whichever is more clearly evident, barter transactions sometimes create difficult audit practice issues. FASB ASC 845-10-30-17 simplifies the auditing of barter transactions by creating a presumption that the fair value of the nonmonetary asset exchanged is more clearly evident than the fair value of the barter credits received. Generally, the barter credits should be recorded at the fair value of the nonmonetary asset given up in the exchange. If the fair value of the asset exchanged is less than its carrying amount, an impairment loss should be recognized prior to recording the exchange. The presumption may be overcome, but only if there is persuasive evidence that the company could convert the barter credits into an amount of cash in the near term that approximates the proposed value.

Subsequent to the initial recording of the barter credit, it may be necessary to recognize an impairment loss if the fair value of unused barter credits is less than the carrying amount or if it is probable that the company will not use all of the remaining barter credits. If the remaining barter credits are long-lived assets or certain amortizable

intangibles, FASB ASC 360-10 establishes accounting standards for the recognition and measurement of impairment losses.

Auditing Considerations. The auditor's primary focus for barter transactions concerns whether there is an impairment loss either on the nonmonetary asset exchanged or, subsequently, on the barter credits remaining. For example, if inventory is exchanged for advertising credits, the auditor may consider whether there is evidence that physical deterioration, obsolescence, changes in price levels, or other causes have reduced the net realizable value of inventory below cost. Generally, the audit procedures are the same as for identifying excess, slow-moving, or obsolete inventory, but the auditor applies them with an added degree of professional skepticism because of the barter transaction. In subsequent periods, the auditor may review the use of the barter credits in relation to prior and projected advertising expenditures to evaluate whether the barter credit asset has become impaired.

Evaluating Impairment

While performing substantive audit procedures, the auditor needs to be alert for signs that any significant assets may be impaired. The following conditions may indicate that an asset has been impaired:

a. A significant decline in the market price of the asset. (This applies particularly to marketable investments.)

b. A significant adverse change in the extent or manner of the asset's use. (For example, a company buys a franchise to sell a particular product and later decides to discontinue selling the product.)

c. A significant adverse change in legal factors or in the business climate that affects the value of the asset or an adverse assessment or action by a regulator. (For example, a purchased contractual right is later invalidated or an asset suddenly becomes obsolete.)

d. Significant cost overruns beyond the amount originally expected to be needed to acquire or build the asset. (For example, costs incurred to acquire a contractual right are substantially higher than expected.)

e. A current period operating or cash flow loss combined with a history of operating or cash flow losses associated with the use of a long-lived asset. (For example, a company owns a franchise right for a retail operation that is experiencing operating or cash flow losses.)

f. Budgets or prospective financial information showing continuing losses associated with an asset. (For example, revenues generated by an asset are not expected to be sufficient to recover the asset's cost over its remaining estimated life.)

g. It is more likely than not that an asset will be sold or disposed of significantly before the end of its estimated useful life. (For example, a purchased contractual right is expected to be sold as part of a transaction to dispose of an unprofitable line of business.)

Cost Method Investments. Impairment indicators specifically related to cost method investments may include the following:

a. Significant deterioration in the investee's earnings, credit rating, assets quality, or business prospects.

b. Significant adverse changes in the investee's regulatory, economic, or technological environment.

c. Significant adverse changes in the investee's industry or geographic market.

d. An offer to buy or sell, or a completed purchase or sale of, the same or similar security at an amount less than cost.

e. Conditions that cause significant concern about the investee's ability to continue as a going concern.

Equity Method Investments. Impairment indicators specifically related to equity method investments may include the following:

- A series of operating losses of an investee.
- Absence of an ability to recover the carrying amount of the investment.

- Inability of the investee to sustain an earnings capacity that would justify its carrying amount.
- A decline in the quoted market price below the carrying amount.

It is not necessary to separately test an investee's underlying assets for impairment. However, the investor should recognize its share of any impairment charge recorded by an investee as part of recording its equity in earnings. It is also necessary to consider the effect of the investee's impairment losses on basis differences discussed earlier, and whether basis differences related to assets written down by the investee should be written down in the investor's financial statements.

Debt and Equity Securities. When the fair value of an available-for-sale or held-to maturity investment is less than its amortized cost at the balance sheet date, a determination needs to be made as to whether the impairment is other-than-temporary. (For purposes of this discussion, the term amortized cost represents the original acquisition cost adjusted for accretion, amortization, collection of cash, other-than-temporary impairment losses previously recognized in earnings, foreign exchange, and fair value hedge adjustments.) The assessment depends on whether the investment is an equity or debt security.

Equity Securities. When making a determination about whether the impairment of an equity security is other-than-temporary, all relevant accounting guidance needs to be considered. If an impaired available-for-sale equity security will be sold shortly after the balance sheet date and the fair value is not expected to recover before the sale date, the security is considered other-than-temporarily impaired in the period the decision to sell is made. (However, an impairment loss needs to be recognized even if a decision to sell has not been made if the impairment is deemed to be other than temporary.)

The following factors may indicate that impairment is other than temporary:

- The length of time and the extent to which the decline in fair value has existed.
- The financial condition and near-term prospects of the issuer of the investment, including any specific events that may influence its operations, industry, or geographic area.
- The reduction or elimination of dividends.
- The intent and ability of an entity to retain the investment for a sufficient period of time to allow for any anticipated recovery in fair value.

Evidence needs to be obtained about the relevant factors and the auditor needs to consider whether the evidence corroborates or conflicts with management's conclusion about whether an other-than-temporary impairment exists.

Debt Securities. Indicators of impairment specifically related to debt securities may include the following:

- Fair value is significantly below cost and—
  - The decline is attributable to adverse conditions specific to the security or specific conditions in an industry or geographic area.
  - The decline has existed for an extended period of time.
  - Management does not have both the intent and ability to hold the security for a sufficient period of time to allow for anticipated recovery in the fair value.
- A rating agency has downgraded the security.
- The issuer's financial condition has deteriorated.
- Scheduled interest or principal payments have not been made.

- Losses from the security were recorded subsequent to year-end.
- Adverse changes have occurred in the present value of current estimated cash flows related to a debt security or beneficial interest.

If an entity intends to sell an impaired debt security, an other-than-temporary impairment is deemed to have occurred. If there is no intention to sell, available evidence needs to be considered to evaluate whether it is more likely than not the entity will be required to sell the security before recovery of the amortized cost basis. If it is more likely than not the entity will be required to sell the security before recovery of amortized cost, the impairment is other-than-temporary.

Even when the entity does not intend to sell an impaired debt security, an assessment needs to be made of whether the entire amortized cost of the security will be recovered by comparing the present value of cash flows expected to be collected with the amortized cost basis. If the present value of cash flows is less than the amortized cost basis (a credit loss), an other-than-temporary impairment exists. All available information relevant to the collectibility of the security, including information about past events, current conditions, and forecasts, needs to be considered when developing an estimate of cash flows expected to be collected.

Goodwill and Other Indefinite-lived Intangible Assets. Currently under GAAP, goodwill is impaired when the fair value of a reporting unit is less than its carrying amount and, similarly, other indefinite-lived intangible assets are impaired when their fair value is less than their carrying amount. (See the discussion of recent changes to goodwill impairment testing later in this section.) For both types of assets, an entity may first assess *qualitative* factors to determine whether it is more likely than not that the asset is impaired as a basis for determining whether it is necessary to perform a *quantitative* impairment test. The *more-likely-than-not* threshold is defined as having a likelihood of more than 50 percent. Examples of factors that should be considered in making a qualitative assessment are as follows:

- The results of any recent fair value determinations for the asset.
- Whether there have been changes to the carrying amount of the asset.
- Positive and mitigating events and circumstances that could affect the inputs used to determine fair value.

Events and circumstances that could affect fair value inputs include the following:

- Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets.
- Industry and market conditions such as a deterioration in the operating environment, an increased competitive environment, a decline in market-dependent multiples or metrics (either absolute or relative to peers), or a change in the market for an entity's products or services.
- Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows.
- Overall financial performance such as negative or declining cash flows, or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.
- Legal, contractual, political, business, or other factors, including asset-specific factors.
- Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation.
- For goodwill, events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

If the qualitative assessment indicates that impairment is not more-likely-than-not, then no further action is required. If the conclusion is otherwise, a quantitative impairment test is the next step.

Authoritative Guidance on Asset Impairment. In situations such as those described earlier, AU-C 501.09 indicates that the auditor should evaluate whether the asset is impaired and the carrying amount of the asset should be written down. Relevant accounting guidance is as follows:

- FASB ASC 360-10, *Property, Plant, and Equipment—Overall*, provides guidance on the determination of and accounting for impaired long-lived assets and amortizable intangibles.
- FASB ASC 350, *Intangibles—Goodwill and Other*, provides guidance on recognition and measurement of impairment losses for goodwill and other intangible assets with indefinite useful lives.
- FASB ASC 323, *Investments—Equity Method and Joint Ventures*, provides guidance on accounting for impairment of investments accounted for using the equity method.
- FASB ASC 320-10, *Investments—Debt and Equity Securities—Overall*, provides guidance on accounting for impairment of investments in debt and equity securities, including investments in equity securities accounted for using the cost method.

AU-C 501.09 further requires the auditor to obtain sufficient appropriate audit evidence and evaluate whether the client complied with GAAP when an impairment adjustment is needed. *PPC's Guide to Preparing Financial Statements* and *PPC's Guide to GAAP* provide guidance regarding measuring impairment losses for various types of assets.

Recent FASB Developments

In January 2017, the FASB issued ASU 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU removes the second step from the current two step impairment test.. The impairment amount under the ASU is the excess of the reporting unit's carrying amount over its fair value, not to exceed the goodwill allocated to the reporting unit. This amount is the amount calculated in the first step of the current impairment test. The ASU also removes the requirement to perform a qualitative impairment assessment for a reporting unit with a carrying amount that is negative or zero, but the existence of such units and the goodwill allocated to them would have to be disclosed. ASU 2017-04 is effective for entities other than public business entities for annual or interim impairment tests in fiscal years beginning after December 15, 2021. Early adoption is permitted for annual or interim impairment tests performed on testing dates after January 1, 2017. The ASU provides special transition guidance for private entities that had previously adopted accounting alternatives for such entities affecting goodwill. Auditors should refer to the ASU for additional guidance.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Which of the following accounting standards apply to the other-asset category of the balance sheet?

    a. Barter credit assets should be recorded at the amount they were paid for by the original owner.

    b. When they are incurred, costs for research and development should be charged to expense.

    c. Long-term investments should be classified as current assets in an entity's financial statements.

    d. Investments in debt and equity securities accounted for using the cost method are written down if they are temporarily impaired.

12. What relevant assertion category does the following belong to?

    Prepaids and other assets that are reflected in the accounts represent a complete listing of the company's costs that are allocable to future periods.

    a. Valuation or allocation.

    b. Rights or obligations.

    c. Completeness.

    d. Existence or occurrence.

13. Which of the following substantive audit procedures for investments, prepaids, and other assets applies solely to the valuation or allocation relevant assertion?

    a. Scan activity during the year in these accounts, compare current asset and expense balances to the ones from the prior year, and investigate unusual items.

    b. Make inquiries about liens, pledged assets, or asset restrictions and relate the information to audit procedures in other areas.

    c. Perform an evaluation of the entity's carrying amounts and unamortized balances for reasonableness.

    d. Consider the proper financial statement descriptions, as well as the balance sheet classification, between current and noncurrent items.

14. Which of the following statements best describes an aspect of obtaining audit evidence for audits of other assets?

    a. If prepaid balances are immaterial, avoid preparing elaborate analysis schedules.

    b. Cash surrender values must be confirmed as of the balance sheet date.

    c. Audit procedures and accounting standards for investments are always complex.

    d. Service auditor's reports are needed any time a custodian holds investment portfolios.

15. What is the first step for auditing derivatives?

    a. The auditor should test completeness (whether all derivative instruments were identified by the client and recorded in the client's financial statements).

    b. The auditor should determine the fair value of all derivatives, hedges and otherwise, held by the client.

    c. The auditor should perform tests of controls at the client or service organization level to limit audit risk for the relevant assertions.

    d. The auditor should focus the audit exclusively on evidence related to cash receipts and disbursements to ensure that the audit is efficient.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Which of the following accounting standards apply to the other-asset category of the balance sheet? **(Page 39)**

    a. Barter credit assets should be recorded at the amount they were paid for by the original owner. [This answer in incorrect. A barter credit asset should be recorded at the fair value of the nonmonetary asset exchanged. Fair value should not be based on an estimate of the barter credits to be received.]

    b. When they are incurred, costs for research and development should be charged to expense. [This answer is correct. According to FASB ASC 730-10-25-1, research and development costs (other than tangible and intangible assets acquired in a business combination that are used for research and development activities) should be charged to expense when they are incurred. Another accounting principle that applies to other assets is that the costs of start-up activities, including organization costs, should be expensed as incurred.]

    c. Long-term investments should be classified as current assets in an entity's financial statements. [This answer is incorrect. Long-term investments should be classified as noncurrent assets in the financial statements, not as current assets.]

    d. Investments in debt and equity securities accounted for using the cost method are written down if they are temporarily impaired. [This answer is incorrect. Investments in debt and equity securities, including investments in equity securities accounted for using the cost method, are written down if they are other-than-temporarily impaired. The loss invalue of an equity method investment that is other than temporary should also be recognized.]

12. What relevant assertion category does the following belong to? **(Page 41)**

    Prepaids and other assets that are reflected in the accounts represent a complete listing of the company's costs that are allocable to future periods.

    a. Valuation or allocation. [This answer is incorrect. A relevant assertion in this category for other assets is to make sure that investments and derivatives are appropriately valued at cost or fair value in accordance with GAAP.]

    b. Rights or obligations. [This answer is incorrect. A relevant assertion in this category for other assets is to ensure that the entity's ownership of investments and derivatives is evidenced by securities or other appropriate legal documents either physically on hand or held in safekeeping by others.]

    c. Completeness. [This answer is correct. This assertion applies to completeness. Another disclosure for prepaids and other assets related to completeness is to make sure that disclosures required by GAAP have been made.]

    d. Existence or occurrence. [This answer is incorrect. A relevant assertion in this category for other assets is to determine that prepaids and other assets reflected in the accounts exist.]

13. Which of the following substantive audit procedures for investments, prepaids, and other assets applies solely to the valuation or allocation relevant assertion? **(Page 42)**

    a. Scan activity during the year in these accounts, compare current asset and expense balances to the ones from the prior year, and investigate unusual items. [This answer is incorrect. This substantive audit procedure applies to five of the six relevant assertions—existence or occurrence, completeness, valuation or allocation, cutoff, and accuracy or classification.]

    b. Make inquiries about liens, pledged assets, or asset restrictions and relate the information to audit procedures in other areas. [This answer is incorrect. This procedure applies to the accuracy or classification assertion and the rights or obligations assertion.]

    c. Perform an evaluation of the entity's carrying amounts and unamortized balances for reasonableness. [This answer is correct. The only relevant assertion this procedure gathers audit evidence for is the valuation or allocation assertion. After making this evaluation, the auditor should consider whether knowledge of the client and its business and industry indicate an impairment that requires a write down or change in useful life.]

    d. Consider the proper financial statement descriptions, as well as the balance sheet classification, between current and noncurrent items. [This answer is incorrect. This substantive audit procedure applies to the valuation or allocation assertion, but it also applies to the accuracy or classification assertion.]

14. Which of the following statements best describes an aspect of obtaining audit evidence for audits of other assets? **(Page 42)**

    a. If prepaid balances are immaterial, avoid preparing elaborate analysis schedules. [This answer is correct. Rarely is prepaid expenses material to the financial statements of any size audit. Audit tests normally should be limited to scanning and analytical procedures, or audit tests should only be applied to material balances. Avoid the temptation to prepare elaborate analysis schedules when the balances are not material.]

    b. Cash surrender values must be confirmed as of the balance sheet date. [This answer is incorrect. Cash surrender values normally are immaterial, but the auditor might feel obligated to confirm those balances as a client service. When balances are confirmed, consider confirming them a month prior to the balance sheet date. The client can adjust the books before year end based on the confirmation. The resulting balance will be incorrect by one month, but that should be immaterial.]

    c. Audit procedures and accounting standards for investments are always complex. [This answer is incorrect. Businesses outside the financial services industry often do not engage in significant investment activities. Accordingly, balances are usually immaterial, or the portfolio of securities has only a few items. Tests in those circumstances are relatively simple. If the entity has large portfolios of securities, the audit procedures and accounting standards can be complex.]

    d. Service auditor's reports are needed any time a custodian holds investment portfolios. [This answer is incorrect. Investment portfolios may sometimes be held by a custodian. In some cases (depending on the nature of transactions processed by the custodian), the auditor may need to consider obtaining a SAS No. 70 (AU 324) service auditor's report.]

15. What is the first step for auditing derivatives? **(Page 51)**

    a. The auditor should test completeness (whether all derivative instruments were identified by the client and recorded in the client's financial statements). [This answer is correct. The first step in auditing derivatives is to test completeness (whether all derivative instruments have been identified by the client and recorded in the financial statements.) One example of a common procedure auditors use to identify derivative instruments is making inquiries of management or the owner/manager to determine if the entity has entered into any contracts that meet the definition of a derivative in FASB ASC 815.]

    b. The auditor should determine the fair value of all derivatives, hedges and otherwise, held by the client. [This answer is incorrect. Though the fair value of derivatives must be determined, it is not the auditor's first step. The fair value of derivatives may be based on quoted market prices, fair value estimates from broker-dealers or other third-party sources, or determined by the entity using a valuation model.]

    c. The auditor should perform tests of controls at the client or service organization level to limit audit risk for the relevant assertions. [This answer is incorrect. In more sophisticated organizations, it may be difficult to limit detection risk for assertions about the completeness of derivatives to an acceptable level without performing tests of controls. Accordingly, the auditor may need to test controls either at the client or at a service organization. However, this is not the first step that an auditor should perform in a derivatives audit.]

    d. The auditor should focus the audit exclusively on evidence related to cash receipts and disbursements to ensure that the audit is efficient. [This answer is incorrect. Because derivatives may not involve an initial net investment, when designing tests for completeness, auditors should not focus exclusively on evidence related to cash receipts and disbursements.]

WORKPAPER CONSIDERATIONS

Workpaper formats for other assets need to be flexible and tailored to the particular type of asset. Too often, workpaper analyses for other assets are complex and time-consuming to prepare. The workpaper content and the extent of the auditor's documentation will generally not be influenced by whether the workpapers are prepared in paper or electronic format. However, if the auditor uses electronic workpapers, client-prepared schedules and detail need to be obtained in electronic format, if possible, to reduce the extent of paper files that will be retained in the audit file or require scanning. This section discusses possible alternatives to the traditional other asset workpapers.

Prepaid Insurance

One of the most time-consuming schedules to prepare is an analysis of prepaid insurance. Such a schedule generally is not necessary if the balance is immaterial. However, if the amounts are material and the auditor decides such an analysis is necessary, the analysis normally has the following column headings:

(1) Insurance Company	(2) Policy Number	(3) Type of Coverage	(4) Coverage Limits	(5) Policy Term

(6) Premium Paid	(7) Date Premium Paid	(8) Prepaid Balance 12-31-X1	(9) Additions	(10) Amortization	(11) Prepaid Balance 12-31-X2

An optional approach that is sometimes effective, especially if the company's insurance policies are in disarray, is to request that the company's insurance agency prepare a listing of insurance policies, including the information listed earlier. The auditor can use that listing to evaluate the prepaid balances on major policies.

Investment Securities and Derivatives

If the company's securities portfolio is significant, analysis schedules need to be obtained showing the details of the portfolio, e.g., type of security, number of shares, date purchased, original cost, current or noncurrent status, fair value, and classification as trading, held-to-maturity, or available-for-sale. Also, an analysis is needed to test activity during the year, e.g., type of security sold, date sold, and cost. Before requesting that such a schedule be prepared, determine if the company's brokerage house already provides that information on summary sheets. If so, request a copy of those analyses from the broker. Similar analyses of open and closed derivative positions may also be needed, including indication of whether the derivative is designated as a hedge and the type of hedge. Best practices suggest that auditors document their discussions with management about the company's investment strategies and purpose in using derivative instruments.

Equity Method Investments

Workpapers for equity method investments normally include copies of the investee's financial statements. Audit procedures and computation of equity in earnings can be documented on the face of those statements or in attached memos.

COMMON OVER (UNDER) AUDITING TENDENCIES

Overauditing and underauditing tendencies, which are discussed in other sections of this lesson, are summarized below.

Overauditing Tendencies

Overauditing or inefficient tendencies include:

a. *Excessive Prepaid Insurance Calculations.* Many auditors routinely recalculate the prepaid insurance balance and reconcile insurance expense to the prepaid analysis without considering materiality. Also, auditors tend to review the adequacy of insurance coverage, even though authoritative accounting and auditing literature does not require such a review.

b. *Analysis of Prepaid Expenses.* For many prepaids, the balance is recalculated regardless of its significance. The client can be requested to present a calculation of the prepaid balance and, in most cases, reviewing the comparative general ledger balances is all that is needed.

c. *Unnecessary Cash Surrender Value Confirmations.* Some auditors send confirmations to verify cash surrender values whenever such policies exist. The auditor needs to determine whether any potentially significant cash surrender values (or significant policy loans) will exist at year end and only confirm those amounts. Also, such balances can be considered for confirmation at an interim period.

d. *Review of Investment Transactions.* Some auditors examine supporting documents for all security transactions during the period. Although it may be appropriate to vouch selected items to supporting documents, it is rarely necessary to apply the procedure to all transactions.

e. *Excessive Physical Inspection of Investments.* Some auditors feel it is necessary to examine support for physical ownership or safekeeping for all investments held. Investments are not significantly different from other types of assets. Investments need not be inspected unless the balances are material and, even if the balances are material, the need for a 100% examination is not likely. The need for and significance of physical inspection depends on the nature and size of the investment holding.

Underauditing Tendencies

Underauditing or ineffective tendencies include:

a. Inadequate inspection or confirmation of the physical existence of major investments.

b. Overlooking testing for impairment in the carrying values of investments, goodwill, and other assets.

c. Failure to require audited financial statements (or to apply audit procedures) for material investments accounted for using the consolidation or equity method. Also, overlooking how a report modification on the financial statements of an investee may affect the auditor's report on the investor.

d. Failure to identify inappropriate selection of accounting methods (cost, equity, or consolidation) for closely held investments.

e. Failure to consider the basis of accounting and financial statement dates used by an investee.

f. Failure to identify temporary differences between book and tax basis of other assets.

g. Failure to apply the accounting requirements of GAAP to material debt and equity securities and derivatives.

h. Overlooking inappropriate capitalization of start-up costs.

i. Failure to identify derivatives.

j. Failure to identify variable interest entities and apply the appropriate accounting requirements of GAAP.

k. For business combinations, failure to understand the scope of the acquisition transaction and consider the completeness of assets acquired and liabilities assumed, along with their proper measurement under fair value standards.

l. Failure to appropriately test the fair values of investments, derivatives, or other assets.

CASE STUDIES

Financial Statement Dates of Investor and Investee Are Different

The general ledger of Greenleaf Nurseries, Inc., an audit client, includes an investment in a subsidiary (Lakewood Landscapes, Inc.) representing 60% ownership in the total Lakewood shares outstanding. The following statistics apply to the two companies at their most recent year end:

	Fiscal Year Ended	Total Assets	Sales	Net Income
Greenleaf	12/31/X2	$ 1,000,000	$ 4,000,000	$ 450,000
Lakewood	1/31/X3	450,000	2,000,000	190,000

Can the auditor consolidate these financial statements for different year ending dates?

Solution. FASB ASC 810-10-15-11 and 810-10-45-12 would allow Greenleaf to consolidate the January 31, 20X3, Lakewood financial statements because the difference in year ends is not over three months. However, disclosure or adjustment should be made in the consolidated financial statements for the effects of any material transactions in the period from December 31, 20X2 to January 31, 20X3.

Losses in a Real Estate Limited Partnership Investment

Grey Manufacturing has a 50% investment in a real estate limited partnership, Townhouse Ltd. Grey is a limited partner, and Grey's initial capital contribution was $100,000. At December 31, 20X1, Townhouse Ltd.'s K-1 tax return shows Grey's tax deductible losses for the year total $150,000 (made up of the initial $100,000 contribution plus $50,000 of additional deductions because of Grey's portion of nonrecourse debt on the financial statements of Townhouse). Grey has a December 31, 20X1 year end, and its financial statements are prepared in accordance with GAAP. What amount should be recorded by Grey for the investment in Townhouse Ltd.?

Solution

The investment should be reduced to zero, but not beyond zero, because Grey has no additional financial obligations to Townhouse due to the $50,000 debt being *nonrecourse*.

Assume that Grey is able to use the $150,000 K-1 tax loss from Townhouse. Are there any temporary differences that require deferred tax accounting? If so, what is the amount of the temporary difference?

Solution

There would be a temporary difference of $50,000, i.e., $150,000 of tax deduction should be recognized (assuming that the amount of Grey's tax deduction is not limited) but the loss for book purposes would remain at $100,000, the amount of the original investment. The difference occurs because real estate partnerships are allowed to deduct losses to the extent of nonrecourse debt. Deferred taxes should be provided on the $50,000 temporary difference.

Losses in an Oil and Gas Tax Shelter Investment

Grey also has a 50% investment in an oil and gas limited partnership, Mineral Exploration (MX), totaling $100,000. Grey is a limited partner, but has guaranteed $100,000 of MX's recourse debt. MX had an excellent year, drilling several successful wells that generated significant proved oil and gas reserves. However, there has been no production to date from the wells, pending the completion of a gathering system. At December 31, Grey received a K-1 form for MX showing deductible losses of $200,000. (The $200,000 losses occurred solely because MX elected to expense the intangible drilling cost on the successful wells.) Assuming that the amount of Grey's tax deduction is not limited, what amount should be recorded on Grey's financial statements for the investment in MX?

Solution

The investment should remain at $100,000, and a $200,000 temporary difference should be recognized. For GAAP purposes, MX would not have shown a loss because intangible drilling cost (IDC) on successful wells is not written off in the year it is incurred. Instead, IDC is amortized on a unit-of-production method over the lives of the properties. If the loss for MX had been a GAAP loss of $200,000, Grey would have recorded a negative investment (liability) of $100,000 because it has guaranteed $100,000 of MX's recourse debt.

RESPONDING TO FRAUD RISK

The auditor may determine that an audit response is necessary. Audit responses may be overall or specific. Overall responses, such as assigning more experienced personnel, introducing a significant element of unpredictability, and considering the extent of supervision planned for the audit, affect the overall conduct of the audit. Auditors generally use overall responses to address fraud risks that are pervasive to the financial statements. Specific responses involve the nature, timing, and extent of further audit procedures. Specific responses are used to address fraud risks in individual audit programs, that is, at the account balance, transaction class, disclosure or assertion level.

Numerous different types of fraud schemes may be used to perpetrate and conceal either fraudulent financial reporting or misappropriation of assets. Auditors need an understanding of fraud schemes and how they can be perpetrated, concealed, detected, and prevented so they can design appropriate audit responses and advise their clients about fraud prevention and detection matters. Examples of common fraud schemes related to investments and other assets and procedures that may be performed in response to those schemes are provided for both misappropriation of assets (Exhibit 3-1) and fraudulent financial reporting (Exhibit 3-2). For misappropriation of assets, Exhibit 3-1 also lists the symptoms (also called red flags or indicators) auditors may observe that indicate a risk of the presence of a particular fraud scheme. For fraudulent financial reporting schemes presented in Exhibit 3-2, symptoms generally relate to fraud risk factors such as the desire to minimize reported earnings for tax-motivated reasons. Those risk factors may provide an incentive or pressure to manipulate the financial statements.

Exhibit 3-1

Common Investment and Other Asset Fraud Schemes, Symptoms, and Related Audit Responses—Misappropriation of Assets

Fraud Scheme	Symptoms	Audit Responses[a]
Theft of investment or diversion of income or gains.	• Unexpected or unexplained fluctuations in investment balances. • Unexpected or unexplained fluctuations in investment-related income or expense accounts.	• Confirm with third party and inspect documents. • Vouch and trace information. • Conduct predictive tests of investment income or expenses. • Review journal entries. • Conduct interviews.
Borrowing schemes.	• Sales of investments from the organization to an employee. • Securities held by unusual party. • Indications that securities may be pledged.	• Review investment documents and records. • Confirm with third party and inspect documents. • Vouch and trace information. • Conduct interviews. • Review journal entries.

Fraud Scheme	Symptoms	Audit Responses[a]
Unauthorized trading with diversion of personal losses to the organization or diversion of gains to the thief.	• Unexpected decreases in realized gains or increases in losses.	• Review and test policy for authorization and execution of trading. • Test for unrecorded trading by selecting items from records of the executing broker.
Fictitious investments [b]	• Unusual types of investments. • Investments acquired from management, employees, owners, or their or the entity's related parties. • Investments acquired in violation of normal investment policies and procedures. • Use of a different-than-normal custodial arrangement.	• Confirm with the issuer or other independent parties • Make inquires of government agencies, if any, that would be expected to register the investments. • Consider consulting an expert to authenticate security certificates. • Determine the legitimacy and viability of the custodian.

Notes:

[a] In addition to the specific responses listed, the auditor may also interview client personnel or third parties in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

[b] Fictitious investments may be ostensibly sold to the entity to misappropriate the entity's assets, or as indicated in Exhibit 3-2, to inflate assets and income to deceive users of the financial statements.

* * *

A risk of misappropriation of assets may exist in many entities. However, the auditor is not responsible for obtaining reasonable assurance of detecting immaterial fraud, and some frauds involving misappropriation of assets may not be material to the financial statements. Consequently, auditors need not automatically perform additional procedures related to misappropriation simply because a risk of misappropriation exists. The auditor should develop an audit response for identified risks of *material* misstatement due to fraud.

Exhibit 3-2

Common Investment and Other Asset Fraud Schemes and Related Audit Responses—Fraudulent Financial Reporting

Fraud Scheme	Audit Responses[a]
Recording fictitious investments, or investments not owned by the company.[b]	• Confirm with third parties and inspect investments. • Determine the legitimacy and viability of investment custodians.
Failing to record sales of investments.	• Confirm with third parties and inspect investments. • Determine the legitimacy and viability of investment custodians.
Misclassifying or misstating the value of investments.	• Review the classification of securities with professional skepticism. • Verify value of securities using published sources or multiple brokers. • Consider whether there has been an other than decline in value for debt securities held until maturity, available-for-sale equity securities, and investments accounted under the equity method.
Failing to disclose liens on securities.	• Review collateral provisions of debt instruments and confirm details of loan agreements with lenders. • Perform procedures to detect unrecorded debt, as illustrated in Exhibit 4-2.
Deferring costs that should be charged to expense.	• Scrutinize documentation supporting amounts capitalized as intangible assets.
Overstating the value of intangible assets.	• Scrutinize documentation supporting amounts capitalized as intangible assets. • Analyze the amortization of intangibles with finite lives and assess the propriety of amortization periods and methods. • Analyze intangible assets for evidence of impairment. (This may require the service of a valuation specialist.)

Notes:

[a] In addition to the specific responses listed, the auditor may also interview client personnel or third parties in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

[b] As indicated in Exhibit 3-1, fictitious investments may be used in fraud schemes to misappropriate assets or to engage in fraudulent financial reporting.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Which of the following is an underauditing tendency for audits of other assets?

    a. Excessive calculations for prepaid insurance.

    b. Unnecessary confirmations of cash surrender value.

    c. Review of all investment transactions.

    d. Inadequate inspection of major investments' physical existence.

17. Ashleigh, a CPA, is engaged to audit HealthCo. During her audit of the company's other assets she discovers sales of investments from the organization to one of its employees. Ashleigh also discovers securities that are held by an unusual party. What type of fraud scheme do these symptoms indicate?

    a. Failure to disclose liens on securities.

    b. Borrowing schemes.

    c. Unauthorized trading with diversion of personal losses to the organization.

    d. Theft of investment.

18. Assume the same facts as in study question 17. What would be an appropriate audit response for Ashleigh to take given the symptoms she discovered?

    a. Review investment documents and records.

    b. Review and test HealthCo's policy for authorization and execution of trading.

    c. Conduct predictive tests of investment income or expenses.

    d. Inspect investments.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Which of the following is an underauditing tendency for audits of other assets? **(Page 63)**

    a. Excessive calculations for prepaid insurance. [This answer is incorrect. This is an overauditing or inefficient tendency related to audits of other assets. Many auditors routinely recalculate the prepaid insurance balance and reconcile insurance expense to the prepaid analysis without considering materiality. Also, auditors tend to review the adequacy of insurance coverage, even though authoritative accounting and auditing literature does not require such a review.]

    b. Unnecessary confirmations of cash surrender value. [This answer is incorrect. This would be considered overauditing, not underauditing. Some auditors send confirmations to verify cash surrender values whenever such policies exist. The auditor should determine whether any potentially significant cash surrender values will exist at year end and only confirm those amounts. Also, such balances should be considered for confirmation at an interim period.]

    c. Review of all investment transactions. [This answer is incorrect. This tendency would be considered overauditing instead of underauditing. Some auditors examine supporting documents for all security transactions during the period. Although it may be appropriate to vouch selected items to supporting documents, it is rarely necessary to apply the procedure to all transactions.]

    d. Inadequate inspection of major investments' physical existence. [This answer is correct. Inadequate inspection or confirmation of the physical existence of major investments is considered an underauditing or ineffective tendency. Other examples of this type of tendency include (1) overlooking testing for impairment in the carrying values of investments, goodwill, and other assets and (2) failure to identify temporary differences between book and tax basis of other assets.]

17. Ashleigh, a CPA, is engaged to audit HealthCo. During her audit of the company's other assets she discovers sales of investments from the organization to one of its employees. Ashleigh also discovers securities that are held by an unusual party. What type of fraud scheme do these symptoms indicate? **(Page 65)**

    a. Failure to disclose liens on securities. [This answer is incorrect. This fraud scheme is related to fraudulent financial reporting. The symptoms that Ashleigh discovered are for a fraud scheme related to misappropriation of the assets.]

    b. Borrowing schemes. [This answer is correct. These are both symptoms of borrowing schemes. Another symptom of this fraud scheme would be if Ashleigh found indications that some of HealthCo's securities had been pledged.]

    c. Unauthorized trading with diversion of personal losses to the organization. [This answer is incorrect. This fraud scheme would be indicated if Ashleigh discovered unexpected decreases in realized gains or increases in losses.]

    d. Theft of investment. [This answer is incorrect. This fraud scheme would be indicated if Ashleigh discovered unexpected or unexplained fluctuations in investment balances or investment-related income or expense accounts.]

18. Assume the same facts as in study question 17. What would be an appropriate audit response for Ashleigh to take given the symptoms she discovered? **(Page 65)**

    a. Review investment documents and records. [This answer is correct. This audit response is appropriate for the fraud scheme that Ashleigh discovered. Other audit responses Ashleigh should consider include vouching and tracing information and conducting interviews.]

    b. Review and test HealthCo's policy for authorization and execution of trading. [This answer is incorrect. This audit response would be correct if Ashleigh had discovered symptoms of unauthorized trading with diversion of personal losses to the organization or diversion of gains to the thief.]

    c. Conduct predictive tests of investment income or expenses. [This answer is incorrect. This audit response would be correct if Ashleigh had discovered symptoms of theft of investment or diversion of income or gains.]

    d. Inspect investments. [This answer is incorrect. This is an audit response associated with failing to record sales of investments. Ashley discovered a different type of scheme.]

Lesson 4: Liabilities and Equity

INTRODUCTION

This lesson discusses the audit of liability accounts (except income taxes and contingencies) and equity accounts. The audit of liabilities normally centers around three classifications of accounts—accounts payable, accrued liabilities, and debt arising from borrowed funds. The audit of owner's equity is influenced by the legal form of organization, e.g., corporation, S corporation, partnership, joint venture, or proprietorship, and the complexity of agreements that affect equity, e.g., restrictive debt covenants or stock options.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify procedures that can be used to obtain audit evidence relevant to liability and equity accounts.
- Recognize how to audit liability and equity accounts by addressing workpaper considerations and commonly occurring problems, such as overauditing, underauditing, and fraud risk.

Accounting Standards

Accounts Payable and Accrued Liabilities. Accounting standards for accounts payable and accrued liabilities focus on the timing of the purchase of an asset, recognition of an expense, or recording of a deposit. Accounts payable for the purchase of goods and services are created with the passage of title to the goods or with the receipt of the benefit from the services. "Trade" payables are usually recorded on the passage of title to items purchased; the point when title passes varies with the terms of purchase. It is common practice to record the liability for purchases when goods are received; however, it is necessary to record material inventory in transit and the related obligation if notice of shipment has been received and title has passed. Accounts payable normally reflect obligations for which creditors' invoices are received, and which constitute liabilities at the balance sheet date. Accounts payable may also include items for which invoices are not received, such as progress payments on construction contracts, employee withholdings, excise taxes, etc.

Contractual obligations (rents, interest, royalties, etc.) and other liabilities, such as taxes, should be recognized at the balance sheet date even though no invoice or statement has been or will be received. Significant known liabilities should be accrued even though the exact amount may not then be determinable. Accrued liabilities usually represent provision for costs that are not immediately payable because the accounting period and the contractual or obligatory period do not coincide. The accrued liabilities are recorded because the related expense has been incurred during the accounting period. Accruals generally require computation by the company; they may not be substantiated either currently or at a later date by a creditor's invoice, as in the case of accounts payable. Costs of disposal activities are accrued only for present obligations owed, not for costs expected to be incurred.

Deposits arising from the receipt of money in advance of the delivery of goods or services are usually treated as liabilities because they will be satisfied by the delivery of goods or rendering of services.

Debt Obligations. Accounting standards for obligations for borrowed funds are concerned primarily with classification and disclosure. The portion of long-term debt obligations maturing within one year, and demand notes and other obligations with a maturity not subject to company control, including debt containing loan covenant violations that the lender will not waive, ordinarily are classified as current liabilities. Debt disclosure standards include disclosure of pledged assets, restrictive loan covenants, interest rates, terms, maturities, etc. An often-overlooked disclosure is a listing of long-term debt maturities for the five years from the balance sheet date, a requirement of FASB ASC 440-10-50.

One of the most complex series of accounting standards related to recognition of debt is FASB ASC 840 on recognition and disclosure of capital leases. In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which among other things, requires the recognition of lease assets and lease liabilities by lessees, including for those leases classified as operating leases under previous GAAP, along with the disclosure of key information about leasing arrangements. When effective, the ASU will supersede FASB ASC 840, *Leases*, and add Topic 842, *Leases*, to the FASB ASC. In addition to replacing FASB ASC 840 with FASB 842, the ASU amends and supersedes a number of other Topics throughout the FASB ASC. The ASU is effective for entities other than public business entities, certain not-for-profit entities, and certain employee benefit plans for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. Users should refer to the ASU for additional information about specific transition and disclosure amendments and requirements. Due to the delayed effective dates, this *course* has not otherwise been updated for the requirements of ASU 2016-02. As the effective date nears, a future edition of this *course* will incorporate any necessary revisions related to the ASU. Users may download the ASU from the FASB's website at **www.fasb.org** or from Checkpoint at **checkpoint.riag.com.** *PPC's Guide to GAAP* and *PPC's Guide to Preparing Financial Statements* provide a summary of ASU 2016-02.

Equity. Accounting standards for equity relate to terminology, the extent of detail to be presented in the equity section of the balance sheet, and the form and content of the presentation of changes in equity during the period. The equity section should be suitably titled, e.g., stockholders' equity, partners' capital, or proprietor's capital. For corporations, the major components of equity—capital stock, additional paid-in capital, retained earnings, and accumulated other comprehensive income—are presented. For partnerships and proprietorships, these distinctions are not made on the balance sheet. FASB ASC 505-10-50 requires that changes in stockholders' equity accounts be disclosed whenever financial statements purport to present financial position and results of operations. Changes in capital are also usually disclosed for entities other than corporations, and S corporations often disclose changes in the separate components of retained earnings. FASB ASC 480 generally requires entities to account for mandatorily redeemable equity interests as a liability. However, the FASB has provided exemptions for nonpublic entities. For those entities, the only equity interests required to be accounted for as a liability are those that must be redeemed on a fixed date and for an amount that is either fixed or referenced to an external index.

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

According to AU-C 500.06, *Audit Evidence*, appropriate audit procedures should be designed and performed to obtain sufficient appropriate audit evidence. AU-C 500.A10 states that those audit procedures consist of risk assessment procedures, tests of controls, and substantive procedures.

Risk assessment procedures and tests of controls contribute to the formation of the auditor's opinion, but do not, by themselves, provide sufficient appropriate audit evidence. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, at AU-C 330.18, states that regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Substantive procedures consist of (a) tests of details of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The auditor uses relevant assertions in assessing the risks of material misstatement by considering the different types of potential misstatements that may occur (that is, what could go wrong in the financial statements), and then designing audit procedures that are responsive to the assessed risks. For each relevant assertion within an account balance, class of transactions or disclosure, the auditor assesses the risks of material misstatement and, based on that assessment, determines the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

Relevant Assertions for Liabilities and Equity

The relevant assertions for liabilities and equity generally are as follows:

	Accounts Payable	Accrued Liabilities	Debt	Equity
Existence or occurrence (E/O)	Accounts payable reflected in the financial statements exist.	Accrued liabilities reflected in the financial statements exist.	Notes payable, long-term debt, and debt equivalents reflected in the financial statements exist.	Equity interests reflected in the financial statements exist.
Completeness (C)	Accounts payable reflected in the accounts represent a complete presentation of authorized current obligations that arose from the purchase of goods and services.	Accrued liabilities reflected in the accounts represent a complete presentation of unpaid costs and expenses for which the benefit has been received in the current period.	Notes payable, long-term debt, and debt equivalents reflected in the accounts represent a complete presentation of authorized debt.	Equity interests reflected in the accounts represent a complete presentation of authorized equity transactions.
Rights or obligations (R/O)	Accounts payable reflected in the accounts are the obligations of the entity.	Accrued liabilities reflected in the accounts are the obligations of the entity.	Notes payable, long-term debt, and debt equivalents reflected in the accounts are the obligations of the entity.	Equity interests reflected in the accounts represent the residual interests in the net assets of the entity that are owed to the owners.
Valuation or allocation (V)	Accounts payable are valued in accordance with GAAP.	Accrued liabilities are valued in accordance with GAAP.	Notes payable are valued in accordance with GAAP.	Equity interests are recorded in accordance with GAAP.

	Accounts Payable	Accrued Liabilities	Debt	Equity
Cutoff (CO)	Accounts payable are recorded in the proper accounting period.	Accrued liabilities are recorded in the proper accounting period.	Notes payable, long-term debt, and debt equivalents are recorded in the proper accounting period.	Equity transactions are recorded in the proper accounting period
Accuracy or classification (A/CL)	Accounts payable are properly classified as current liabilities, and disclosure is made of related party payables, payables with explicit payment terms, and assets pledged as collateral against payable balances.	Accrued liabilities are computed, classified and described in a consistent manner.	Notes payable, long-term debt, and debt equivalents are properly classified between current and long-term portions, and required disclosures have been made.	Equity interests are recorded correctly as to account and amount, and the equity section of the balance sheet is properly described and disclosed in accordance with GAAP and legal requirements.

Substantive Audit Procedures for Liabilities and Equity

The audit of liabilities concentrates primarily on the financial statement assertions of completeness, cutoff, and the presentation and disclosure assertions of accuracy or classification. The other assertions—existence or occurrence, rights or obligations, and valuation—are addressed within the audit procedures designed to test the primary assertions. The audit of equity concentrates primarily on the financial statement assertions of existence, especially the authorization aspect of existence, and accuracy or classification. Disclosures should consider both legal and accounting requirements. In other respects, the auditor's approach to equity is similar to the audit of debt because there are generally very few transactions that are material in amount. The following paragraphs describe examples of substantive audit procedures for those audit areas.

Accounts Payable. Examples of substantive procedures for accounts payable are as follows:

- Compare the balances in trade accounts payable and purchases with those of prior years, relating the level of activity to inventory and sales levels, and investigate any unusual fluctuations.
- Trace receiving cutoff information obtained during the inventory observation to the accounting records, noting whether the liability for merchandise is recorded in the proper accounting period.
- Scan the listing of accounts payable for related party accounts payable and any other unusual items and consider whether appropriate financial statement disclosures have been made.
- Inquire of the client about their knowledge of unprocessed invoices and whether accruals have been made for such items.
- Perform a search for unrecorded liabilities by reviewing support for material disbursements and remaining unprocessed invoices subsequent to the balance sheet date to determine if related liabilities were properly accrued.

The auditor's decision about the extent of procedures necessary to obtain sufficient appropriate audit evidence depends, in part, on the sophistication of the accounting system. If the company does not record year-end expense accruals, the auditor may propose the necessary adjustments as a bookkeeping service. Many small businesses

operate on a cash basis throughout the year and recognize accounts payable only at year-end. In those situations, procedures might be performed to control and list unpaid invoices as of year-end. Also, the extent of the search for unrecorded liabilities procedures might be increased, for example, by reducing the auditor's scope or examining invoices through the date of the auditor's report. Accounts payable cutoff tests need to be coordinated with inventory procedures to determine if cutoff adjustments affect inventory or cost of sales.

Accrued Liabilities. Examples of substantive procedures for accrued liabilities are as follows:

- Compare the balances in accrued liabilities with those of prior years and investigate any unusual results.
- Scan the working trial balance and determine those accrued liabilities that require additional testing, such as predictive tests; consider whether immaterial balances are reasonable and whether any necessary accruals have been omitted.
- Scan expense accounts in the working trial balance and compare balances with prior periods or other expectations. Investigate unusual fluctuations or the absence of accrued expense items that existed in prior periods.

Substantive analytical procedures that may be appropriate to test material accruals depend on the nature of the accrual. One example is comparison of the accrued amount divided by the related expense, such as accrued property taxes divided by property tax expense, for the current and prior period. Accruals that are paid in the next month, such as payroll, can be tested by computing the ratio of the number of days expense being accrued to the number of days in the payment period and multiplying the ratio times the next month's payment. For estimates such as warranty expense payable, the auditor can compare the ratio of warranty expense to units sold in the current period to the same ratio for the prior year and current budget. In some cases, a comparison of warranty expense to costs of sales is sufficient. For employee benefit related items, the expense and accrual can be related to the number of covered employees.

Debt. Examples of substantive procedures for debt are as follows:

- Compare balances of notes payable, long-term debt, capitalized lease obligations, and other financing transactions and related interest expense with those of prior years and investigate any unusual results.
- Confirm significant notes that are not confirmed on the standard bank confirmation.
- Analytically test the reasonableness of accrued interest and accrued interest payable.
- Consider the need to impute interest on any noninterest bearing notes.

Inspecting loan documents and lease agreements and review of minutes, which may be done as part of the general procedures program, together with client inquiries also provide audit evidence about restrictive covenants.

Equity. Examples of substantive procedures for equity are as follows:

- Read minutes and note authorized equity transactions. (This procedure may be done as part of the general procedures program.)
- Compare balances in the equity accounts with those of the prior year; test significant transactions (for example, examine supporting documents) and consider whether they are accounted for in accordance with GAAP.
- Test significant transactions that occurred in capital stock, paid-in capital, contributed capital, or treasury stock by examining supporting documents.
- Scan the retained earnings account for unusual transactions that might indicate improper accounting. Reconcile changes in retained earnings to net income for the period.

- Review the analysis of other comprehensive income for the period and agree the activity to testing performed in other audit areas.

- Review new agreements associated with rights or restrictions on equity accounts (for example, debt agreements, buy-sell agreements, or related options to buy company stock), consider whether any transactions resulting from such agreements are accounted for in accordance with GAAP, and summarize restrictions on equity for disclosure in the financial statements.

Much of the audit evidence regarding the equity accounts may already be available in the prior year's workpapers, which only need to be updated for any transactions in the current year.

Financial Statement Disclosures. The primary matters related to presentation and disclosure that are considered in the audit programs at the account balance and transaction class level are (a) the proper classification of accounts for financial statement presentation (classification) (for example, the current and long-term classification of capital lease obligations and debt) and (b) ensuring that the workpapers include the information needed for required disclosures and that such information has been subjected to appropriate audit procedures (occurrence, accuracy, and valuation). Accuracy and classification is further considered by agreeing or reconciling the financial statements to the general ledger. The completeness and understandability of disclosures are ordinarily considered in the steps in the general auditing and completion program.

The Role of Sampling in Substantive Tests

In most audits, sampling is not used in auditing accounts payable. One reason is that sampling procedures generally are more effective in testing for overstatement (i.e., existence assertion) while accounts payable procedures are directed primarily toward testing for understatement (i.e., completeness assertion). Also, sampling normally is not an efficient application for:

a. *Search for Unrecorded Liabilities.* Sampling generally is effective only when the population consists of numerous items and little or no misstatement is expected. In many small business audits, the auditor expects some unrecorded liabilities. Also, the population from which items are selected (subsequent cash disbursements) is not the account balance about which audit conclusions are being formed, and a sample size cannot readily be determined that meets the requirements of AU-C 530. Accordingly, it is normally more efficient and effective to examine items over a specified dollar amount instead of sampling.

b. *Confirmation with Vendors.* Accounts payable confirmation typically is used only to supplement the search for unrecorded liabilities. Thus, if confirmation procedures are performed, confirmation with major vendors is generally sufficient and sampling is unnecessary.

External Confirmation Considerations

It is often unnecessary to confirm accounts payable to obtain sufficient appropriate audit evidence about accounts payable recorded in the financial statements. A search for unrecorded liabilities generally is an appropriate completeness test for payables. However, it is best practice to confirm accounts payable in the following situations:

- There is a high risk of material misstatement that accounts payable are incomplete, and the period for conducting the search for unrecorded liabilities is not considered long enough to detect material unrecorded liabilities.

- The client has extended payment terms with vendors.

- There are significant debit memos included in the accounts payable balances.

- Based on consideration of identified fraud risks, the auditor decides to modify procedures related to accounts payable balances.

When confirmation procedures are necessary, the auditor should comply with the provisions of AU-C 505, *External Confirmations*.

Type of Confirmation Request. The two primary types of confirmations are (a) a request of the creditor to confirm the balance in the company's records and (b) a request of the creditor to furnish the balance along with a copy of the vendor statement (sometimes referred to as a "blind" request). Often, the more effective and efficient method for payables is the blind request because:

a. the vendor does not have to agree with the company's balance or reconcile the information,

b. a detailed vendor's statement provides information necessary to reconcile balances, and

c. confirmation requests can be prepared and mailed before the company's determination of accounts payable.

Confirmation request letters may be sent via physical mail or via email. Whether paper or electronic, the auditor should control the mailing of the confirmation request and should consider validating the addressee information in response to assessed fraud risk. Some audit firms choose to use online confirmation services as part of their confirmation procedures. Best practices indicate that using email or online confirmation services may improve the response rate, as it is more convenient and less likely to get lost than a physical letter. In addition, some entities, especially larger companies, have a central "clearinghouse" for confirmation letters that online confirmation services have on file and contact directly. However, there is additional risk to consider when using electronic communications. AU-C 505.A14 states that the validity of responses received electronically (i.e. via email) may be subject to additional risk because proof of respondents' identities may be difficult to determine and alterations to responses may be difficult to identify. As such, the auditor may consider performing additional procedures, such as contacting respondents directly via telephone, to further validate the source and the contents of the response.

In lieu of sending accounts payable confirmations, auditors might be able to access a client's accounts payable balance or outstanding vendor invoice detail directly through the vendor's online system. (However, the auditor ought to consider any risks associated with this process to ensure that the identity of the of vendor information is valid.)

Timing of Confirmations. Confirmations of accounts payable need to be sent on, or shortly before, the balance sheet date, so the vendor can respond to the auditor's request through the normal billing process. Vendors are more likely to respond if they are not required to take special steps outside their normal time for billing. If the physical inventory is conducted before the balance sheet date, the auditor may also confirm accounts payable at that earlier date.

Selection of Specific Accounts for Confirmation. Accounts selected for confirmation ought to include primarily major suppliers of goods or services. The auditor needs to select vendors based on a review of purchase journals, disbursement journals, and prior months' accounts payable listings. (It may be efficient to maintain a carryforward list of major suppliers in the permanent file and update it annually.) Because the accounts are selected before the accounts payable listing is prepared, the selection usually includes some accounts of new vendors, accounts expected to have a small or zero balance, and accounts payable to officers/related parties. Otherwise, once a client became aware of the vendors that were selected for confirmation, it would be possible to understate accounts payable and expenses by delaying the recording of certain purchases from other vendors until after the audit was completed.

Reconciliation of Confirmation Responses. Differences between the vendor's confirmed balance and the company's recorded balance can occur for a number of reasons. Differences caused by payments in transit and shipments in transit normally are not unrecorded liabilities. However, the auditor ought to vouch significant timing differences to disbursement records and receiving reports. Nontiming differences such as clerical errors, disputes with vendors, and unrecorded invoices need to be investigated and a determination made of whether a misstatement exists in the client's balance. Alternative procedures normally are not necessary on nonreplies because the search for unrecorded liabilities normally compensates for those alternative procedures. However, if the auditor believes that the misstatements noted when processing confirmation replies are not isolated, testing needs to be

expanded by performing alternative procedures on other balances. Such procedures may include one or more of the following:

a. Obtain statements received by the client and reconcile as necessary.

b. Confirm orally by telephone.

c. Examine documentation supporting payments after the balance sheet date.

d. Examine unpaid invoices held by the client.

e. Determine the existence of vendors not replying by looking them up on the Internet or in trade directories, telephone books, etc.

Search for Unrecorded Liabilities

As previously discussed, the auditor is primarily concerned about completeness (understatement of liabilities). If risk is low, the search for unrecorded liabilities may be limited to the following steps:

a. Inquiring of responsible client personnel about their knowledge of unprocessed invoices and whether accruals have been made for such items.

b. Reviewing receiving cutoff information obtained during the inventory observation.

However, it is usually necessary for the auditor to also perform the following procedures, the extent of which depends on the risk assessment:

- Obtain and examine supporting detail for material disbursements after the balance sheet date and determine whether the goods or services on the paid invoices were received on or before the balance sheet date. If so, determine whether the liability was included in accounts payable at the balance sheet date.

- Inspect files of unprocessed invoices, vendor statements, and unmatched receiving documents. If the goods or services were received on or before year-end, determine whether the liability is included in the accounts payable listing (or the listing of accrued liabilities).

If the company uses a voucher system, the same procedures are performed, except the auditor may examine transactions vouchered after the balance sheet date and unvouchered invoices rather than cash disbursements and unpaid invoices. When designing the search for unrecorded liabilities, the auditor needs to consider the system used by the client.

It is not necessary to inspect every vendor invoice or disbursement. Normally, a dollar amount is established, and transactions equal to or greater than that amount are inspected. That dollar amount ordinarily is determined based on the amount of coverage (that is, the percent coverage of subsequent disbursements) desired, considering the auditor's assessment of the risk of material misstatement. Other transactions below that amount can be scanned for reasonableness. If the search procedures reveal unrecorded inventory purchases, an audit adjustment may be necessary to debit either inventory or cost of sales, depending on whether the inventory balance already includes those purchases. If the search procedures reveal unrecorded liabilities for services that have been rendered or assets where title has passed, the proposed adjustment would be to the appropriate expense or asset account. To meet the requirements of AU-C 230.09, the workpapers should identify the items inspected (for example, the auditor may identify the source and selection criteria, such as "all disbursements over $2,000 from the cash disbursements journal for the period 1/1/X2 through _____").

Accrued Liabilities

Accrued liabilities normally include the following:

a. Accrued salaries or bonuses.

b. Employee and employer withholding and FICA taxes payable.

c. Compensated absences, such as vacation, sick leave, holiday, etc.

d. Accrued commissions.

e. Accrued property taxes.

f. Accrued interest, normally tested in conjunction with the audit of the debt.

g. Accrued professional fees.

h. Costs relating to employee benefit plans (such as pension plans, ESOPs, or other postretirement benefits).

i. Costs relating to benefits provided former employees (such as severance, insurance, or educational benefits).

j. Accrued sales taxes.

k. Claims incurred but not reported (IBNR), for example, for self-insured insurance claims.

The substantive audit procedures for accrued liabilities focus on supporting the methods of determining the accrued amounts. For defined benefit plan accruals the auditor might perform additional procedures to test disclosure of actuarial present values of vested and nonvested benefits. Many smaller accruals such as accrued property taxes can be tested through analytical procedures. The auditor needs to also consider whether revenue/expense procedures indicate accruals not recorded. Focusing only on a schedule of accrued liabilities prepared by the client can result in the auditor failing to identify unrecorded accruals. Understanding the client's business and thinking about the types of liabilities accrued by other clients can help identify missing items. In addition, recorded accruals that appear immaterial need to be evaluated to consider the likelihood of a material understatement of the balance. The auditor does not document that the balance is immaterial, but rather that the balance is reasonable based on the auditor's knowledge of the account. However, that does not require preparation of extensive analysis schedules for immaterial accrued expenses.

Other Considerations for Accrued Liabilities

Presentation and disclosure requirements include disclosure of material commitments and contingencies. A commitment is an existing agreement or responsibility to perform, such as long-term leases, pension plans, contracts for capital asset acquisition, letters of credit, etc. Contingencies include existing conditions, situations, or sets of circumstances that involve a degree of uncertainty as to whether a liability will be incurred. Audit procedures performed in all areas plus inquiries of legal counsel provide audit evidence regarding commitments and contingencies.

Notes Payable and Debt Obligations

Generally, confirmation of debt terms provides the auditor with sufficient appropriate audit evidence for relevant assertions for notes payable and debt obligations. However, auditors may decide not to confirm debt that was confirmed in prior years. With the increasing complexity of debt agreements, inspection of loan agreements is also often a necessary procedure to identify restrictive covenants, pledged assets, terms, etc. That inspection, along with inquiry of the client, provides the auditor with details about the financing arrangement to confirm with the financial institution. Details of financing agreements and transactions, such as lines of credit, collateral and pledged assets, loan agreements and related covenants, and contingent liabilities, including oral and written guarantees, are normally confirmed directly with the appropriate party at the financial institution responsible for the client's account. All returned confirmations need to be retained in the workpapers. Sample confirmation letters are included in the CL section. Also, inspection of lease documents is normally performed in the notes payable procedures to identify capital leases.

If inspection of the loan agreement reveals a debt covenant violation, it may be necessary to classify the loan as a current liability. According to FASB ASC 470-10, debt that is callable because of such violations should be classified as current unless one of the following conditions is met:

a. The lender has waived or lost the right to call the loan within a year from the balance sheet date.

b. The loan has a grace period that allows the debtor to cure the covenant violation within that period and it is probable that the violation will be cured.

Accounting for loan defaults is discussed in more detail in *PPC's Guide to Preparing Financial Statements*. When auditors find loan covenant violations, they need to request that the client obtain a waiver letter, unless the company cures the violation within the grace period. Additional considerations when assessing the client's compliance with loan covenants and obtaining waivers are discussed later in this lesson.

Some long-term loan agreements include "due on demand" clauses. In those cases, classification of the debt depends on whether the client obtains an unconditional waiver of the lender's rights to call the debt for over one year from the balance sheet date. If an unconditional waiver is obtained, the debt can be classified as noncurrent. If such a waiver is *not* obtained, the debt should be classified as current. Also, some loan agreements have subjective acceleration clauses, which allow the lender to call the debt based on subjective criteria such as "material adverse changes." FASB ASC 470-10-45-2 and 470-10-50-3 apply to these situations. In the authors' opinion, if the auditor believes that it is likely the lender will call the loan based on such criteria, the debt should be classified as current unless the acceleration clause is waived unconditionally for over one year from the balance sheet date. If the likelihood of acceleration of the due date is remote, neither reclassification of the debt nor disclosure of the existence of the clause is required. Evidence that the likelihood of acceleration of the due date is remote includes:

a. History with the lender (the lender hasn't accelerated due dates of loans containing similar clauses).

b. The entity's financial condition is strong.

Classification of revolving debt agreements can also be an issue. According to FASB ASC 470-10-45-3 through 45-6, if a line of credit both (a) contains a subjective acceleration clause and (b) requires customer payments to be made directly to a lock-box account that is then applied directly to the outstanding balance of the line of credit, it needs to be classified as a current liability even though the agreement may not expire until more than one year after the balance sheet date. These agreements may be fairly common and the classification issues can be easily overlooked by basing the classification on the expiration date of the agreement.

When a client obtains a waiver letter for a covenant violation or a demand clause, the auditor needs to evaluate whether the waiver is sufficient to classify the debt noncurrent. To be an adequate waiver, the lender must have forfeited the right to call the loan because of that clause or that violation, and the waiver needs to extend throughout the next fiscal year. If not, the waiver is inadequate and the debt should be classified as current. The authors offer the following additional guidance for evaluating the effectiveness of waiver letters:

a. Wording such as "the violation of the debt to equity ratio is waived at December 31, 20X1" would not be sufficient because the violation would theoretically reoccur on January 1, 20X2, requiring the debt to be classified as a current liability.

b. Wording such as "The lender does not presently intend to enforce its rights under the Agreement" would not be sufficient because the lender may change its intentions during the next fiscal year.

c. A waiver through some date before the end of the next fiscal year would not be sufficient if the company is likely to be in violation of the debt covenant at that point.

d. When the violation relates to a single transaction, such as a sale of equipment without obtaining bank approval, the waiver need only extend through the balance sheet date, if there are no other violations after that date.

In addition, the auditor needs to consider the following procedures to address the possible effects of loan covenants:

a. Obtain written acknowledgement of lender waivers of loan covenant violations and of the lender's lack of knowledge of any violations or intent to call the debt. An oral agreement by a financial institution to waive a covenant violation is not sufficient evidence to classify debt as long-term. Covenant waivers need to be carefully evaluated to determine whether the lender has truly waived the right to call the loan.

b. Carefully review loan amendments that management represents as curing a violation of a loan covenant to assess whether the lender has waived or amended all covenants or clauses providing the right to call the loan.

c. Consider obtaining a legal opinion from the client's attorney in respect to technical covenant violations.

d. Obtain representations from management regarding known covenant violations and communications with creditors regarding violations or waivers during the period.

e. Assess the effect of passed audit adjustments on the client's compliance with loan covenants.

f. Consider the effects of escalating quarterly loan covenants that cover the quarterly period rather than the end of the quarter. These covenants may cause the client to be in compliance at the end of one quarter but to be immediately in noncompliance if a more restrictive covenant is effective for the next quarterly period beginning on the following day. Written waivers of these covenants may also need to be obtained.

g. Be alert for "cross default" provisions where a violation of one loan covenant affects other loan covenants.

AU-C 700.41 requires the auditor's report to be dated no earlier than the date the auditor has obtained sufficient audit evidence to support the auditor's opinion. Accordingly, auditors should not date their audit report until they have obtained written waiver of covenant violations, and their subsequent events procedures should be extended to that date.

FASB ASC 470-10-45 refers to "short-term obligations" as those scheduled to mature within one year after the date of a company's balance sheet. Normally such obligations are included in current liabilities. However, they may be included with noncurrent liabilities if *both* of the following conditions are met:

a. *Intent to Refinance*—The company intends to refinance the obligation on a long-term basis.

b. *Ability to Consummate the Refinancing*—Ability may be demonstrated in either of the following ways:

(1) *Post Balance Sheet Date Issuance of a Long-term Obligation or Equity Securities.* After the balance sheet date but before the financial statements are issued, a long-term obligation or equity securities have been issued for the refinancing.

(2) *Financing Agreement.* Before the financial statements are issued, the company has entered into a financing agreement that clearly permits refinancing on terms that are readily determinable, and all of the following conditions are met:

(a) the agreement does not expire within one year (or within the operating cycle) from the balance sheet date and the agreement is not cancelable by the lender (or callable) except for violation of a provision with which compliance is objectively determinable or measurable;

(b) no violation of any provision in the agreement exists at the balance sheet date, and no available information indicates that a violation has occurred prior to the issuance of the financial statements, or if there has been a violation, a waiver has been obtained; and

(c) the lender is expected to be financially capable of honoring the agreement.

Tests of interest expense and accrued interest usually include an overall calculation, based on the average principal amounts outstanding during the period and contractual interest rates. If this computation results in a reasonable expense when compared to recorded interest expense, the adequacy of accrued interest payable is also tested. A significant difference between the auditor's computation and recorded interest expense could indicate the existence of a derivative.

Equity Accounts

The typical audit procedures for equity accounts are inspection of company documents and vouching significant transactions. Company documents include articles of incorporation, bylaws, and minutes. For a partnership, the partnership agreement or contract is a significant document because it specifies division of profits and related matters such as maintenance of capital at specified levels and restrictions on partners' drawings.

A small corporation generally tracks equity transactions in a detailed spreadsheet or, in some instance, may maintain a stock certificate book. The auditor inspects the schedule of transactions or certificate book, reconciles the information on number of shares issued, canceled, and held in treasury, and compares the accounting records. Also, the auditor needs to inspect company agreements that create rights or restrictions related to equity accounts, e.g., debt agreements, stock option plans, or buy-sell agreements.

The auditor also generally vouches significant transactions affecting equity accounts, e.g., dividends or other changes in retained earnings and capital additions or reductions, to supporting documents and should document the items selected. Also, the auditor will need to consider whether those transactions were authorized and appropriate by reference to minutes, agreements, and legal requirements.

Accounting for certain equity transactions can be complicated and small business auditors may not frequently encounter complex equity transactions. When auditing equity transactions, therefore, it may be necessary to consult other accounting or auditing professionals.

A client may report accumulated other comprehensive income related to items such as unrealized holding gains or losses on securities, changes in fair value of certain derivative instruments in accordance with FASB ASC 815, items associated with pension or other postretirement benefit plans, or foreign currency translation adjustments. These balances generally can be audited by rolling forward the balance from the previous period, reviewing the propriety of classifications, and agreeing the activity in the accounts to the related testing in other areas. For example, changes in accumulated other comprehensive income related to unrealized gains and losses on available-for-sale securities are ordinarily tested in conjunction with the procedures performed to audit investments. The auditor also needs to evaluate whether reclassifications out of accumulated other comprehensive income, such as occurs when there is a sale of available-for-sale securities on which there are unrealized gains or losses, are properly accounted for and disclosed. An area that is often overlooked is the need to allocate income tax expense or benefit to each component of other comprehensive income.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following accounting standards applies to liabilities other than debt?

    a. Deposits arising from advance payments for the delivery of goods and services should be treated as assets.

    b. Even though no invoice will be received, contractual obligations and other liabilities should be recognized at the balance sheet date.

    c. Long-term debt obligations that will mature within one year, as well as demand notes and obligations with maturities not subject to company control, are usually classified as current liabilities.

    d. Capital stock, additional paid-in capital, retained earnings, and accumulated other comprehensive income is presented for corporations, but not partnerships or proprietorships.

20. The following substantive procedure applies to what part of liabilities and equity audit?

    Test significant transactions that occurred in capital stock, paid-in capital, contributed capital, or treasury stock by examining supporting documents.

    a. Equity.

    b. Debt.

    c. Accrued liabilities.

    d. Accounts payable.

21. In which of the scenarios below should the auditor confirm accounts payable?

    a. North Company has significant debit memos included in its accounts payable balances.

    b. East Company's auditor determines that fraud risk and risk of material misstatement are low.

    c. South Company's auditor uses sampling to search for unrecorded liabilities in accounts payable.

22. In which of the following scenarios could the auditor deem a client's waiver letter for a covenant violation or a demand clause sufficient to classify the debt as noncurrent?

    a. Northland Limited obtains a waiver for a covenant violation that says, "the violation of the debt to equity ratio is waived at December 31, 20X1."

    b. Southland's waiver extends through the next fiscal year and the lender forfeits the right to call the loan because of the demand clause.

    c. The Eastland Group's waiver says, "The lender does not presently intend to enforce its rights under the Agreement."

    d. The Westland Company may be in violation of its debt covenant by December 31, 20X1. Its waiver extends to April 30, 20X2.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following accounting standards applies to liabilities other than debt? **(Page 73)**

    a. Deposits arising from advance payments for the delivery of goods and services should be treated as assets. [This answer is incorrect. The correct accounting standard for this aspect of liabilities other than debt is that deposits arising from the receipt of money an advance of the delivery of goods or services are usually treated as liabilities because they must be satisfied by the delivery of goods or rendering of services.]

    b. Even though no invoice will be received, contractual obligations and other liabilities should be recognized at the balance sheet date. [This answer is correct. This accounting standard applies to liabilities other than debt. Contractual obligations (rents, interest, royalties, etc.) and other liabilities, such as taxes, should be recognized at the balance sheet date even though no invoice or statement has been or will be received.]

    c. Long-term debt obligations that will mature within one year, as well as demand notes and obligations with maturities not subject to company control, are usually classified as current liabilities. [This answer is incorrect. This accounting standard applies to debt obligations, not liabilities other than debt.]

    d. Capital stock, additional paid-in capital, retained earnings, and accumulated other comprehensive income is presented for corporations, but not partnerships or proprietorships. [This answer is incorrect. This accounting standard applies to equity, not liabilities other than debt.]

20. The following substantive procedure applies to what part of liabilities and equity audit? **(Page 77)**

    Test significant transactions that occurred in capital stock, paid-in capital, contributed capital, or treasury stock by examining supporting documents.

    a. Equity. [This answer is correct. This substantive audit procedure applies to equity. Another relevant substantive audit procedure is to read minutes and note authorized equity transactions.]

    b. Debt. [This answer is incorrect. A substantive audit procedure related to debt is to confirm significant notes that are not confirmed on the standard bank confirmation.]

    c. Accrued liabilities. [This answer is incorrect. A substantive audit procedure related to accrued liabilities is to scan the working trial balance and determine those accrued liabilities that require additional testing, such as predictive tests, and to consider whether immaterial balances are reasonable and whether any necessary accruals have been omitted.]

    d. Accounts payable. [This answer is incorrect. A substantive audit procedure related to accounts payable is to scan the listing of accounts payable for related party accounts payable and any other unusual items and consider whether appropriate financial statement disclosures have been made.]

21. In which of the scenarios below should the auditor confirm accounts payable? **(Page 78)**

    a. North Company has significant debit memos included in its accounts payable balances. [This answer is correct. In this situation, North Company's auditor should consider confirming accounts payable. Other situations when confirmations should be considered include when a client has extended payment terms with vendors and when there is a high risk that accounts payable are incomplete, and the period for conducting the search for unrecorded liabilities is not considered long enough to detect material unrecorded liabilities.]

    b. East Company's auditor determines that fraud risk and risk of material misstatement are low. [This answer is incorrect. Confirmation of accounts payable could be done if, based on consideration of identified fraud risks, the auditor decides to modify procedures related to accounts payable balances.]

    c. South Company's auditor uses sampling to search for unrecorded liabilities in accounts payable. [This answer is incorrect. Sampling is not relevant to the decision of whether or not to confirm accounts payable. In most audits, sampling is not used in auditing accounts payable. When searching for unrecorded liabilities, it is normally more efficient to examine items over a specified dollar amount instead of sampling.]

22. In which of the following scenarios could the auditor deem a client's waiver letter for a covenant violation or a demand clause sufficient to classify the debt as noncurrent? **(Page 82)**

    a. Northland Limited obtains a waiver for a covenant violation that says, "the violation of the debt to equity ratio is waived at December 31, 20X1." [This answer is incorrect. Based on this wording, the violation would theoretically reoccur on January 1, 20X2, which requires the debt to be classified as a current liability.]

    b. Southland's waiver extends through the next fiscal year and the lender forfeits the right to call the loan because of the demand clause. [This answer is correct. When a client obtains a waiver letter for a covenant violation or a demand clause, the auditor must evaluate whether the waiver is sufficient to classify the debt noncurrent. To be an adequate waiver, the lender must have forfeited the right to call the loan because of that clause or that violation, and the waiver must extend throughout the next fiscal year. If not, the waiver is inadequate and should be classified as current.]

    c. The Eastland Group's waiver says, "The lender does not presently intend to enforce its rights under the Agreement." [This answer is incorrect. This wording is not sufficient to deem the debt noncurrent because the lender may change its intentions during the next fiscal year.]

    d. The Westland Company may be in violation of its debt covenant by December 31, 20X1. Its waiver extends to April 30, 20X2. [This answer is incorrect. A waiver through some date before the end of the next fiscal year would not be sufficient to classify the debt as noncurrent if the company is likely to be in violation of the debt covenant at that point.]

WORKPAPER CONSIDERATIONS

The workpapers listed below are commonly used to document the performance of the liabilities audit procedures. The workpaper content and the extent of the auditor's documentation will generally not be influenced by whether the workpapers are prepared in paper or electronic format. However, if the auditor uses electronic workpapers, client-prepared schedules and detail need to obtained in electronic format, if possible, to reduce the extent of paper documents that will be retained in the audit file or require scanning.

a. Schedule of trade accounts payable by vendor.

b. Analysis of notes payable and related interest accounts.

c. Capital lease amortization schedule.

d. Analysis of various accrued expenses as deemed necessary.

e. Summary analysis schedule of beginning balances, transactions, and ending balances for all equity accounts. (If some transaction categories include numerous transactions, supporting schedules of transactions may be prepared, e.g., dividends paid, stock issued, etc.)

Schedule of Trade Accounts Payable

The schedule needs to show vendor name, detail of the balance owed, and any other information that may assist in reconciling confirmation responses, such as invoice numbers, vendor's account number for the company, etc. Information about aging of accounts is also beneficial.

Analysis of Notes Payable

The workpaper format for notes payable needs to be flexible and tailored to the type of debt maintained by the company. Information about classification and note disclosures can be accumulated on the face of the confirmation. If a company has a large volume of loan activity, a more sophisticated schedule may be necessary. For example, a schedule that summarizes the activity for each individual note may be prepared. These schedules can take more time to prepare than it takes to audit the individual note; however, they may be helpful when drafting the statement of cash flows and footnote disclosures. If possible, have the client prepare the schedule. Such a schedule may have the following column headings:

a. Notes payable balance at beginning of period.

b. Notes incurred or additional advances.

c. Note principal payments.

d. Notes payable balance at end of period.

e. Maturities in each of the five years after the balance sheet date.

f. Accrued interest at beginning of period.

g. Interest expense or additional accruals.

h. Interest payments.

i. Accrued interest at end of period.

Capital Lease Amortization Schedule

The schedule needs to show, for each periodic lease payment, the amount allocated to reduction of the lease obligation and the amount allocated to interest expense. It needs to also reflect the unamortized balance of the lease obligation as of each payment date for the life of the lease.

Analysis of Accrued Expenses

Workpapers for accrued liabilities need to be designed to describe the method of calculating the accrued amount and the financial information needed to apply the computation. The format of such schedules will vary with the type of liability involved.

Summary Schedule of Equity Accounts

Many entities have only a few simple equity transactions. This means the auditor can usually design one schedule to summarize all procedures for equity accounts. All details the auditor intends to test can be identified in the analysis. The schedule needs to include a description of the equity units, such as shares of stock, and, normally, matters requiring disclosure, such as restrictions on dividends, can also be included on the same schedule.

COMMON OVER (UNDER) AUDITING TENDENCIES

This section summarizes overauditing and underauditing tendencies that have been discussed in other sections of this lesson.

Overauditing Tendencies

Overauditing or inefficient tendencies include:

a. Confirming accounts payable when there is a moderate or low risk of understatement.

b. When accounts payable are confirmed, postponing selection of accounts payable confirmations until the account listing has been completed. This delays response time and may overlook vendors who are not recorded on the listing.

c. Performing extensive alternative procedures on nonreplies when such tests normally are not necessary.

d. Preparing extensive analysis schedules for immaterial accrued expenses.

e. Performing extensive testing of notes payable and accrued interest for companies with a simple debt structure.

f. Performing complex interest tests when analytical procedures may be adequate.

g. Attempting to apply sampling procedures to liability accounts.

h. Attempting to vouch all equity transactions when, in the rare case, equity transactions are voluminous.

Underauditing Tendencies

Underauditing or ineffective tendencies include:

a. If accounts payable are confirmed, sending confirmations to only material outstanding balances at the balance sheet date.

b. Lack of proper inspection of debt instruments.

c. Inadequate inspection of lease documents that overlooks capital leases. Also, disclosures for both capital and operating leases are often overlooked.

d. Inadequate testing of disclosure information required for employee benefit plans, especially defined benefit pension plans.

e. Inappropriate timing of accounts payable work. It may be necessary to perform some accounts payable testwork as of the same date as the inventory observation.

f. Inadequate coordination of procedures for the search for unrecorded liabilities. For example, the auditor only examines subsequent disbursements without considering unprocessed invoices after the balance sheet date.

g. Overlooking appropriate classification of note agreements containing "due on demand" or subjective acceleration clauses.

h. Overlooking violations of debt covenants, legal requirements, or equity agreements.

i. Overlooking disclosure of long-term debt maturities for each of the five years following the balance sheet date.

j. Failing to consider whether the company has the ability to pay current debt maturities or to refinance the debt.

k. Overlooking the need to impute interest when the stated interest rate on notes payable exchanged for property, goods, or services is not reasonable in comparison with prevailing market conditions.

l. Failing to identify unrecorded accruals.

CASE STUDY

Audit Sampling and the Search for Unrecorded Liabilities

XYZ Company has an accounts payable balance of $800,000 at 12-31-X1. The auditor has established planning materiality at $40,000 and tolerable misstatement for accounts payable at $30,000. The auditor believes the risk of a material misstatement of accounts payable arising from unrecorded liabilities is high. He expects to find some, but relatively little, misstatement. As part of the search for unrecorded liabilities, the auditor plans to select a sample of cash disbursements subsequent to the balance sheet date and has estimated a sample size using the formula explained earlier [(population's recorded amount ÷ tolerable misstatement) × risk factor]:

$$\frac{\$800{,}000}{\$30{,}000} \times 3 = 80$$

Is this approach acceptable?

Solution: This approach is not acceptable. The auditor has defined the population improperly. The account balance of $800,000 used to determine sample size is not the population from which the auditor is selecting sample items.

Generally, the most efficient approach for searching for unrecorded payables is to avoid sampling. The auditor establishes a cutoff amount and examines all disbursements in the subsequent period above the cutoff amount. The cutoff is determined based upon the amount of coverage desired, considering the auditor's assessment of the risk of material misstatement. The auditor needs to keep in mind that the population being tested is subsequent disbursements, not the year-end accounts payable balance.

Another procedure the auditor may want to consider is the possibility of confirming accounts payable in conjunction with examining subsequent disbursements. The auditor can select vendors for confirmation on the basis of activity during the period rather than the size of the year-end payable balance, e.g., the 5, 10, or 25 vendors having the highest volume of annual purchases, in addition to selected other vendors. The number of vendors is determined judgmentally because the auditor is identifying significant vendors and not sampling.

RESPONDING TO THE FRAUD RISK ASSESSMENT

The auditor may determine that an audit response is necessary. Audit responses may be overall or specific. Overall responses, such as considering the extent of supervision planned for the audit, affect the overall conduct of the audit. Auditors generally use overall responses to address fraud risks that are pervasive to the financial statements. Specific responses involve the nature, timing, and extent of auditing procedures. Specific responses are used to address fraud risks in individual audit programs, that is, at the account balance, transaction class, or financial statement assertion level.

Numerous different types of fraud schemes may be used to perpetrate either fraudulent financial reporting or misappropriation of assets. Auditors need an understanding of fraud schemes and how they are perpetrated, concealed, detected, and prevented so they can design appropriate audit responses and advise their clients about fraud prevention and detection matters. Examples of common fraud schemes related to liabilities and equity and procedures that may be performed in response to those schemes are provided for both misappropriation of assets (Exhibit 4-1) and fraudulent financial reporting (Exhibit 4-2). For misappropriation of assets, Exhibit 4-1 also lists the symptoms (also called red flags or indicators) auditors may observe that indicate the presence of a particular fraud scheme. For fraudulent financial reporting schemes presented in Exhibit 4-2, symptoms generally relate to fraud risk factors such as the desire to minimize reported earnings for tax-motivated reasons. Those risk factors may provide an incentive or pressure to manipulate the financial statements.

Exhibit 4-1

Common Liabilities and Equity Fraud Schemes, Symptoms, and Related Audit Responses—Misappropriation of Assets

Fraud Scheme	Symptoms	Audit Responses[a]
Unauthorized borrowing	• Unexpected liens on company assets. • Unusual or unexpected changes in lifestyle of potential suspects.	• Confirm or contact lenders. • Search public records and credit reports. • Examine loan documents. • Interview lender.
Diversion of loan proceeds.	• Unexpected loss of cash flow.	• Vouch and trace loan proceeds.
Diverting equity proceeds for personal use.	• Unexpectedly low cash flow.	• Vouch and trace equity proceeds.
Underpaying dividends and diverting the difference.	• Complaints from investors. • Unusual payees or endorsements on dividend checks.	• Vouch and trace. • Confirm with third parties.
Selling the same shares of stock more than once.	• Missing, duplicate, or forged stock certificates. • Complaints from investors.	• Vouch and trace. • Conduct interviews.

Note:

[a] In addition to the specific responses listed, the auditor may also interview client personnel in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

* * *

A risk of misappropriation of assets may exist in many small businesses. However, the auditor is not responsible for immaterial fraud, and many frauds involving misappropriation of assets are not material to the financial statements. Consequently, auditors need not automatically perform additional procedures related to misappropriation simply because a risk of misappropriation exists. The auditor should develop an audit response for identified risks of *material* misstatement due to fraud.

Exhibit 4-2

Common Liabilities and Equity Fraud Schemes and Related Audit Responses—Fraudulent Financial Reporting

Fraud Scheme	Audit Responses[a]
Failing to disclose status of loan covenants.	• Confirm with lenders.
Misclassifying currently maturing debt as long-term (especially for covenant violations, demand clauses, or acceleration clauses).	• Inspect loan documents. • Confirm with lenders. • Analyze status of loan covenants. • Recompute current maturities of long-term debt.
Unrecorded debt or undisclosed liens on assets (such as recording loan proceeds as cash sales).	• Confirm with lenders. • Search public records (such as UCC filings). • Inspect credit reports. • Inspect accounting records and supporting documentation. • Inspect board of directors minutes for authorization of debt.
Failing to record or understating contingent liabilities.	• Analyze legal expenses for evidence of work on pending or threatened litigation. • Review documentation of pending or threatened litigation. • Communicate with the organization's attorneys. • Analyze other potential contingencies (warranty costs, guarantees of other debt, standby letters of credit, losses on firm commitments, etc.).
Recording debt as equity.	• Analyze the terms of equity arrangements and compare to current accounting treatment. • Confirm terms of agreements with shareholders if necessary.
Understating dividends.	• Inspect stockholder records, articles of incorporation, board of directors' minutes, etc. to determine the required dividend levels. • Inspect records of dividends paid. • Analyze dividend calculations.
Failing to recognize receivables or seller obligations for issuance of stock.	• Inspect agreements for equity transactions. • Vouch cash proceeds from sale of stock. • Inspect board of directors' minutes for evidence of unusual terms of stock sales. • Confirm details of transactions (including whether there are any side agreements) with the stockholders.

Note:

[a] In addition to the specific responses listed, the auditor may also interview client personnel in areas where the auditor is concerned about the risk of fraud or test controls designed to detect the fraud. The auditor's overall response to fraud risks involves more general, or overall, considerations separate from the specific responses illustrated. Overall responses may include assigning more experienced personnel, exercising a heightened degree of scrutiny, and introducing a significant element of unpredictability in the procedures applied.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Which of the following is a common overauditing tendency related to liability and equity audits?

    a. Applying sampling procedures to an entity's liability accounts.

    b. Lack of proper inspection of an entity's debt instruments.

    c. Failing to identify any unrecorded accruals.

    d. Inefficient testing of disclosure information required for employee benefit plans.

24. During the course of his liabilities and equity audit, Nate, an auditor, discovers unusual payees or endorsements on dividend checks. What fraud scheme does this symptom indicate, and what is one audit response Nate can use to deal with the problem?

    a. Underpayment of dividends and diverting the difference; confirming with third parties.

    b. Unauthorized borrowing; confirming or contacting lenders.

    c. The sale of stock shares more than once; vouching and tracing.

    d. Undisclosed liens or unrecorded debt on assets; inspection of credit reports.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. Which of the following is a common overauditing tendency related to liability and equity audits? **(Page 89)**

    a. Applying sampling procedures to an entity's liability accounts. [This answer is correct. This is a common overauditing tendency related to equity and liability accounts. Another example of such a tendency is confirming accounts payable when there is a moderate or low risk of understatement.]

    b. Lack of proper inspection of an entity's debt instruments. [This answer is incorrect. This is a common tendency for underauditing, not overauditing.]

    c. Failing to identify any unrecorded accruals. [This answer is incorrect. This failure is an instance of underauditing, not overauditing.]

    d. Inefficient testing of disclosure information required for employee benefit plans. [This answer is incorrect. This is a common tendency for underauditing, not overauditing.]

24. During the course of his liabilities and equity audit, Nate, an auditor, discovers unusual payees or endorsements on dividend checks. What fraud scheme does this symptom indicate, and what is one audit response Nate can use to deal with the problem? **(Page 91)**

    a. Underpayment of dividends and diverting the difference; confirming with third parties. [This answer is correct. Another audit response is to vouch and trace dividend payments.]

    b. Unauthorized borrowing; confirming or contacting lenders. [This answer is incorrect. This answer choice describes the unauthorized borrowing fraud scheme and the appropriate audit response is to confirm or contact lenders. The symptom would be unexpected liens on company assets.]

    c. The sale of stock shares more than once; vouching and tracing. [This answer is incorrect. A symptom of this fraud scheme is missing, duplicate, or forged stock certificates.]

    d. Undisclosed liens or unrecorded debt on assets; inspection of credit reports. [This answer is incorrect. This fraud scheme is related to fraudulent financial reporting. The fraud scheme associated with the symptom in the scenario above is related to misappropriation of assets.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 1—Cash Balances, Property, Other Assets, and Liabilities and Equity (ASBTG181)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.tr.com**/**ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $95 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($95 for email or fax; $105 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     ASBTG181 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($95 for answer sheets sent by email or fax; $105 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $271 (a 5% discount on all three courses). If you complete four courses, the price for

grading all four is $342 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $404 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **March 31, 2019**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 1—Cash Balances, Property, Other Assets, and Liabilities and Equity (ASBTG181)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Generally, how do cash balances and related procedures compare with the total audit effort devoted to the balance sheet?

   a. Cash is an insignificant portion of the total assets, but it accounts for a large share of the total audit effort.

   b. Cash is a significant portion of the total assets, and it accounts for a large share of the total audit effort.

   c. Cash is an insignificant portion of the total assets, and it accounts for a small share of the total audit effort.

   d. Cash accounts for a small share of total audit time because the related procedures only apply to fraud detection.

2. What type of audit procedures provides sufficient appropriate audit evidence?

   a. Risk assessment procedures.

   b. Tests of controls.

   c. Substantive procedures.

   d. Do not select this answer choice.

3. What is the only substantive procedure that is generally useful for audits of cash balances?

   a. Scanning.

   b. Management inquiry.

   c. Predicting account balances based on timing.

   d. Reviewing confirmations from financial institutions.

4. Which of the following workpapers would help Cindy Lou, a CPA, be more efficient in documenting work performed on several small bank accounts?

   a. Standard tickmark sheet.

   b. Memos.

   c. Program sign off.

   d. Elaborate documentation.

5. Which of the following is an overauditing tendency common to cash audits?

   a. Matching individual deposit slip items to accounts receivable.

   b. Testing material cash accounts.

   c. Not relating facts to other audit areas.

   d. Testing completeness of the outstanding checklist.

6. Who is responsible for identifying and assessing risks of material misstatement due to fraud in an audit?

   a. Client's management.

   b. Client's financial institution.

   c. Auditor.

   d. AICPA.

7. Frank, an auditor, notes the following things while auditing his client's cash balances: cash receipts and deposits differ from normal patterns, there are inventory discrepancies, the client has a lack of segregation of duties, certain deposit slips and sales invoices are missing, and the daily list of receipts differs from deposits on the bank statement. What fraud scheme is indicated by these symptoms?

   a. Theft of a daily deposit.

   b. Skimming all or part of a cash sale.

   c. Shorting of the deposit.

   d. Theft of cash on hand.

8. Discrepancies between the account balance and the cash count is an example of which of the following fraud scheme?

   a. Sales returns and void schemes.

   b. Theft of cash on hand.

   c. Daily deposit theft.

   d. Skimming part of a cash sale.

9. How does the balance sheet's property component often compare to the total audit?

   a. Property makes up a significant portion of total assets but, in comparison, takes a much smaller portion of the total audit time.

   b. Property does not have to be audited every year because the accounts do not change materially, if at all, for years at a time.

   c. Property makes up an insignificant portion of total assets and takes a correspondingly small portion of the total audit time.

   d. Property makes up a significant portion of total assets and takes a correspondingly large portion of the total audit time.

10. How should a CPA allocate the purchase price to individual items in a *basket purchase*?

    a. The purchase price is divided evenly between each item purchased.

    b. The purchase price is allocated to each item based on relative fair values.

    c. The purchase price is allocated to each item based on its estimated useful life.

    d. The purchase price is allocated to the item with the largest number of units in the total purchase.

11. The following relevant assertions are based on which of the following categories?

    Balances in the depreciation allowance accounts are reasonable, considering the estimated salvage values and estimated useful lives of the property.

    a. Existence or occurrence.

    b. Completeness.

    c. Rights or obligations.

    d. Valuation or allocation.

12. Which of the following statements best describes an audit of the property component of the balance sheet?

    a. Generally, auditors will assess the risk of material misstatement associated with a property audit as low.

    b. The purchase and disposition of property and equipment is generally done with little input or control from management.

    c. Property transactions occur frequently, but are relatively low dollar amounts when compared with other balance sheet areas.

    d. Substantive audit procedures are seldom required to provide an auditor with enough audit evidence related to property.

13. If the auditor's assessment of the risks of material misstatement for one or more assertions is high, additional substantive procedures such as the following might be performed for property. Which of the following is **not** one of those procedures?

    a. Examining the property schedule and determine if the lives of assets are reasonable.

    b. Reviewing lease agreements for significant assets and determining if the assets have been properly capitalized.

    c. Evaluating analyses of maintenance and repairs and vouching to determine whether significant or unusual items should have been capitalized.

    d. Evaluating impairment analyses and testing the client's method and assumptions.

14. Which of the following is one example of a workpaper that is common when performing property audit procedures?

    a. Flexible workpapers tailored to the unique type of asset in question.

    b. Property accounts summary schedule.

    c. A lead schedule that reflects all cash accounts.

    d. A trial balance that reflects all cash accounts.

15. Larry, a CPA, is analyzing and repair maintenance accounts because the account balance totals for Limited, Inc.'s accounts are material and the risks of material misstatement dictate a review of the analysis. Which of the following information does Limited need to provide to Larry?

    a. Vendor identification.

    b. Estimated useful life.

    c. Date of disposal.

    d. Current-year retirements and dispositions of assets.

16. What is the primary purpose of an analysis of repairs and maintenance accounts?

    a. Identify the description of the nature of the expenditure.

    b. Identify property additions that may have been improperly expensed.

    c. Identify improperly capitalized costs.

    d. Identify estimated useful life.

17. Thompson-Thomson Enterprises replaces a significant number of vehicles by trading in the old vehicles and paying additional cash. How should this be recorded for book purpose?

    a. Unless the exchange meets an exception in FASB ASC 845, it should be recorded based on fair value.

    b. The exchange will be recorded the same way for both tax purposes and book purposes.

    c. The exchange only has to be recorded if the client incurs a loss or if the boot exceeds 25% of the fair value of the exchange.

    d. New assets are recorded at the basis of the traded-in asset plus the additional boot. No gain or loss is recognized.

18. Which of the following property fraud schemes is related to fraudulent financial reporting?

    a. Failing to remove assets disposed of from the books.

    b. Manipulation of records to conceal other fraud.

    c. Personal use of assets.

    d. Theft of property.

19. Which of the following would best be classified in the *other* assets category of the balance sheet?

    a. Cash.

    b. Derivatives.

    c. Property.

    d. Do not select this answer choice.

20. Which of the following would be classified as rights or obligations for prepaids and other assets?

    a. Prepaids and other assets, as well as any related write-downs or amortization, are recorded in the proper accounting period.

    b. Investments and derivatives reflected in the entity's accounts actually exist.

    c. Information about investments and derivatives (e.g., restrictions or liens against the assets) is disclosed fairly at appropriate amounts.

    d. Prepaids and other assets that are reflected in the accounts are the assets of the entity.

21. Lydia, a CPA, is auditing Moore Enterprise's balances for prepaids, investments, and other assets that are immaterial. Which of the following substantive audit procedures should Lydia use?

    a. Vouching.

    b. Inquiry and analytical.

    c. Confirmation and inspection.

    d. Vouching, inquiry, confirmation, inspection, and analytical procedures.

22. Which of the following substantive audit procedures for investments, prepaids, and other assets applies solely to the valuation assertion?

    a. Consider the proper financial statement descriptions, as well as the balance sheet classification, between current and noncurrent items.

    b. Perform an evaluation of the entity's carrying amounts and unamortized balances for reasonableness.

    c. Make inquiries about liens, pledged assets, or asset restrictions and relate the information to audit procedures in other areas.

    d. Scan activity during the year in these accounts, compare current asset and expense balances to the ones from the prior year, and investigate unusual items.

23. Moore Enterprises has an investment of 15% of the outstanding voting stock of Les Limited. Les Limited qualifies as a closely held company of Moore Enterprises. What accounting method should Moore Enterprises use for this investment?

    a. Consolidation.

    b. Equity.

    c. Cost.

    d. Moore is free to select the method that provides the best outcome.

24. Which of the followings statements best describes an aspect of accounting for investments in closely held companies?

    a. The investee's financial statements can generally be used for its fiscal period if the difference from the investor's is three months or less.

    b. Even if an investment is reduced to zero, the investor must continue to apply the equity method.

    c. The financial statements of the investor and the investee can use different bases of accounting.

    d. Investments of 30% to 60% of the investee's outstanding voting stock are accounted for by the consolidation accounting method.

25. Which of the following is **not** a characteristic of a derivative?

    a. Has at least one notional and at least one underlying amount or payment provision or both.

    b. Must be a stand-alone contract.

    c. Does not require an initial investment.

    d. Its terms allow or require net settlement.

26. What type of accounting treatment generally should be used for a derivative that is classified as a cash flow hedge?

    a. Gain or loss on the hedge should be included as a component of other comprehensive income until the forecasted transaction affects earnings.

    b. Gain or loss in fair value should be reported as part of the cumulative translation adjustment in comprehensive income.

    c. Gain or loss on both the hedged item and the derivative should be included in earnings in the period of change.

    d. Gain or loss on the hedge should be expensed in the period of change.

27. If a derivative instrument is a designated hedge, which of the following must be done for the derivative to qualify for hedge accounting?

    a. Nothing special must be done; all hedges qualify for hedge accounting.

    b. Derivatives activity and significant terms must be confirmed with the counterparty to the contract.

    c. Specific documentation requirements must be complied with as of the hedge's inception.

    d. Specific documentation requirements must be complied with as of the beginning of the current period.

28. Holly, a CPA, is auditing barter credits for Elm Enterprises. What should Holly's primary concern be?

    a. If the nonmonetary asset exchanged or the barter credits remaining suffered an impairment loss.

    b. If the asset acquired in the transaction was recorded at fair value.

    c. If the proper amount of skepticism was used when the audit procedures were performed.

    d. Do not select this answer choice.

29. What should Nate, a CPA, include in his workpapers if he has a client who has equity method investments?

    a. Copies of the investee's financial statements and audit procedures and computation of equity in earnings documented on the face of the statements or in attached memos.

    b. Analysis schedules that show portfolio details and test activity during the year. Analyses of open and closed derivative positions should be included if necessary.

    c. A complex analysis schedule related to the other asset in question that includes eleven column headings.

    d. Do not select this answer choice.

30. Shoeville has a 50% investment in Boots Ltd., a limited partnership. Shoeville is a limited partner. Its initial capital contribution was $50,000. At December 31, 20X2, Boots Ltd.'s K-1 tax return shows Shoeville 's total tax deductible losses for the year as $75,000 (the initial contribution plus $25,000 of additional deductions based on Shoeville 's portion of nonrecourse debt on the financial statements of Boots Ltd.). Shoeville has a December 31, 20X2 year end, and its financial statements are prepared in accordance with GAAP. What amount should Shoeville record for the investment in Boots Ltd.?

    a. ($25,000).

    b. $0.

    c. $50,000.

    d. $75,000.

31. Legit Industries hires John, a CPA, to audit the company's financial statements. While auditing Legit's other assets, John discovers evidence that the company has misclassified or misstated the value of investments. What audit response would be appropriate in this scenario?

    a. John should review the classification of securities with professional skepticism.

    b. John should inspect investments and confirm with third parties.

    c. John should perform procedures to detect unrecorded debt.

    d. John should scrutinize documentation that supports amounts capitalized as intangible assets.

32. May, a CPA, is performing an audit. May is testing to see if the accounts payable reflected in the accounts payable represent a complete presentation of authorized current obligations that arose from the purchase of goods and services. What assertion is she testing?

    a. Cutoff.

    b. Accuracy or classification.

    c. Existence.

    d. Completeness.

33. Which of the following is an example of substantive procedures for accounts payable?

    a. Comparing the balances in accrued liabilities with those of prior years and examining any unusual results.

    b. Considering the need to impute interest on any noninterest bearing notes.

    c. Asking the client about their knowledge of unprocessed invoices and whether accruals have been made for such items.

    d. Reviewing the analysis of other comprehensive income for the period and agree to the activity testing performed in other audit areas.

34. Which of the following statements best describes the confirmation of accounts payable?

    a. The most efficient and effective method for confirming a payable is a blind request.

    b. Confirmations need to be sent so vendors can address them outside of their normal billing process.

    c. The auditor should confirm vendor accounts that are pre-selected by the client.

    d. An extensive amount of alternative procedures should be applied to any nonreplies.

35. During her inspection of a loan agreement, Madeline, an auditor, reveals a debt covenant violation. How might Madeline need to classify the loan?

    a. As a current liability.

    b. As a noncurrent liability.

    c. As a contingency.

    d. As an accrued liability.

36. Which of the following procedures could help Violetta, an auditor; address the possible effects of the loan covenants of Emerald Industries?

    a. Obtain an oral agreement of lender waivers of loan covenant violations.

    b. Assess how the client's compliance with loan covenants is affected by passed audit adjustments.

    c. Accept loan amendments that, according to management, cure a loan covenant violation.

    d. Do not select this answer choice.

37. What are the typical audit procedures for equity accounts?

    a. Reviewing receiving cutoff information and making relevant inquiries of client personnel.

    b. Vouching significant transactions and inspecting company documents.

    c. Scanning bank reconciliations and testing balances using analytical procedures.

    d. Testing all instances of "cross default" provisions and reviewing loan amendments.

38. Which of the following is an overauditing tendency related to an audit of liability and equity accounts?

    a. Excessive physical inspection of the entity's investments.

    b. Capitalizing the entity's leases when the difference is a material amount.

    c. Overlooking any violations of legal requirements, equity agreements, or debt covenants.

    d. Confirming accounts payable when a low or moderate risk of understatement has been assessed.

39. During his audit of Young Industries; Greg, an auditor, discovers an unexpectedly low cash flow. What fraud scheme is this an indication of?

    a. Recording debt as equity.

    b. Diverting equity proceeds for personal use.

    c. Selling shares of stock more than once.

    d. Unauthorized borrowing.

40. Inspecting the board of directors' minutes for authorization of debt is a response to which of the following fraud schemes?

    a. Undisclosed liens on assets or unrecorded debt.

    b. Failing to record or understating contingent liabilities.

    c. Recording debt as equity.

    d. Understating dividends.

GLOSSARY

Account analyses: One type of supporting schedule that can be included in audit workpapers. An analysis shows the activity in a balance sheet account. It starts with the beginning balance, shows the transactions (additions and reductions) affecting the balance, and concludes with the ending balance. Significant types of transactions might be summarized in the account analysis and shown on a cross-referenced supporting schedule. Account analyses are often prepared for investments; allowance for doubtful accounts; property, plant, and equipment; long-term debt; and owner's equity accounts.

Account balance file: The largest part of the workpapers will be schedules supporting the trial balance accounts.

Adjusted consolidated planning materiality: If the auditor decides to perform detailed audit procedures on significant accounts at some subsidiaries and does not perform analytical procedures or other substantive procedures at the remaining subsidiaries, an adjustment to consolidated planning materiality should be considered. The adjustment is necessary to take into account the fact that part of the population for a significant account or class of transactions will not be subject to audit procedures.

Audit workpapers: The main purpose of audit workpapers is to provide the principal support for the auditor's report, including (1) the representation that the audit was performed in accordance with generally accepted auditing standards and (2) the opinion expressed (or disclaimed) on the financial statements. Other purposes of the audit workpapers include aiding in engagement planning and performance, providing guidance for newer team members, and providing audit evidence for future years.

Audit report date: The date that the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements.

Condensed classified trial balance: This type of trial balance shows only the components of financial statements (line items). The account balances that support these components are shown, in detail, in lead or summary schedules.

Consolidated or combined financial statements: While many audits involve only one entity, it is not uncommon for a business or its owner to have ownership interests in other businesses. In those situations, auditors are sometimes asked to audit consolidated or combined financial statements.

Consolidated planning materiality: If the auditor has been engaged to report on only the consolidated financial statements, planning materiality should be calculated based on the consolidated financial statements (that is, use a consolidated benchmark such as consolidated total assets or consolidated total revenues). Consolidated tolerable misstatement should be used to determine the scope of audit procedures to be applied to specific account balances or classes of transactions at each subsidiary.

Comparison schedules: One type of supporting schedule that can be included in audit workpapers. A comparison is a side-by-side presentation of amounts in the accounting records with other relevant information, such as prior years' amounts, budgeted amounts, related operating data, industry statistics, or calculations made by the auditor to test overall reasonableness. It is the workpaper record of applying most types of analytical procedures. Comparison schedules are often used to document analytical procedures, especially for revenue and expense accounts.

Comparative financial statements: If comparative financial statements are presented, two of the alternatives are, technically, equally acceptable: (1) the predecessor may reissue the report on the prior period financial statements or (2) the successor may refer to the predecessor's report in the scope paragraph of the report on the current period financial statements. Occasionally, the reaudit option may occur. In a reaudit, an auditor may be asked to audit and report on a client's financial statements for a period that was previously audited and reported on by a predecessor auditor.

Data extraction software (DES): This type of software allows an auditor to extract information from the client's computer files for analysis and testing.

Detailed classified trial balance: This type of trial balance lists all the general ledger accounts, but the accounts are grouped and subtotaled by financial statement component (line item).

Documentation completion date: Final assembly and completion of the audit file should occur within 60 days of the report release date.

General file: This file contains forms, schedules, correspondence, etc., that are not directly related to the financial statement components and supporting schedules.

General ledger trial balance: The backbone of the workpapers. For a small business the trial balance (1) serves as the means for accumulating and arranging general ledger account balances to prepare financial statements; (2) aids planning, review, and control of audit work by showing the relative importance and relationship of account balances and by identifying supporting schedules; (3) serves as an overall index of the workpapers for specific account balances; and (4) aids in ensuring that all balances have been tested (either through detailed procedures or analytical procedures).

Individual subsidiary planning materiality: If the auditor will express an opinion on the consolidated financial statements and issue a separate opinion on one or more subsidiaries, a separate planning materiality and tolerable misstatement should be determined based on the financial statements of each entity for which a separate report will be issued.

Lists or trial balances: One type of supporting schedule that can be included in audit workpapers. A list shows the detail making up an ending balance of a balance sheet or income statement account. An analysis shows the activity during the year. A list, in contrast, shows only the items included in the ending balance. This type of workpaper schedule is often used for accounts receivable, accounts payable, repair and maintenance expense, miscellaneous income and expense, and legal expense.

Paperless audits: In recent years, the auditing profession has moved to performing paperless audits. Paperless engagement software tools range from program generators to assist staff in planning and risk assessments to comprehensive applications that allow an engagement team to perform virtually all of its work via computer. Underlying all of these software applications is a common desire to increase effectiveness and efficiency.

Permanent file: The workpapers in this file are either general information about the client's organization and operations or specific documents supporting transactions over several accounting periods.

Predecessor auditor: An auditor who (1) reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements and (2) has resigned or been notified that his or her services have been or may be terminated.

Procedure descriptions or results: One type of supporting schedule that can be included in audit workpapers. A description of procedures or results is limited solely to explaining auditing procedures applied or the results of applying procedures. It might be a summary of the results of procedures, e.g., summary of inventory observations or an explanation of procedures applied to supporting documents. It might also be documentation gathered by an auditor when applying procedures, e.g., confirmation replies, representation letters from the client or lawyers, copies of client agreements, etc.

Reconciliation schedules: One type of supporting schedule that can be included in audit workpapers. A reconciliation relates an amount in the accounting records to another source of information. It supports an account balance by showing that the balance agrees with other information. Common reconciliations include: cash book balance with bank statement, subsidiary accounts receivable balances with customer confirmation, or accounts payable balances with vendors' statements.

Report release date: The date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most audits, this will be the date that the auditor delivers the report to the client.

Service organization: A service organization is an entity (or a segment of it) that provides services to a client organization. Examples of such organizations include (1) bank trust departments that invest and hold assets for employee-benefit plans, (2) EDP service centers that process transactions and related data for others, (3) service centers that provide data-processing services, (4) insurers that maintain the accounting for ceded reinsurance, (5) mortgage bankers or savings and loan associations that service loans for others, and (6) shareowner accounting organizations for investment companies.

Single-period financial statements: One option when replacing a predecessor auditor is to present only the current period's financial statements. This approach does not change the auditor's responsibility in applying auditing procedures for opening balances or for consistent application of accounting principles. However, it does avoid a number of problems that potentially may arise when the financial statements audited by a predecessor are presented.

Specialist: A person who possesses a special skill or knowledge in a particular field other than accounting or auditing. Examples include (1) appraisers used to value real estate collateral for a note receivable, (2) valuation specialists used to value businesses, derivatives, or certain types of assets, (3) environmental consultants used to estimate environmental remediation costs, and (4) information technology specialists.

Supplementary information: Information that is presented along with the basic financial statements but is (1) not required for a fair presentation in conformity with GAAP or an OCBOA and (2) not a part of the basic financial statements. The extent of supplementary information may range from a single schedule or consolidating statements to numerous schedules, details, and comments of a financial or nonfinancial nature.

Unclassified trial balance: This type of trial balance simply lists accounts in general ledger order.

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This index is a list of general topics discussed in this course. More specific key word searches can be performed using the search feature of this PDF.

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COMPANION TO PPC'S GUIDE TO AUDITS OF NONPUBLIC COMPANIES

COURSE 2

RISK ASSESSMENT PROCEDURES AND PLANNING (ASBTG182)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course looks at risk assessment procedures and planning necessary for audits of nonpublic companies.

PUBLICATION/REVISION DATE: March 2018

RECOMMENDED FOR: Users of *PPC's Guide to Audits of Nonpublic Companies*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 9 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **March 31, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Risk Assessment, Other Planning Procedures, and Understanding the Entity and Its Environment

Completion of this lesson will enable you to:
- Recognize what risk assessment and other planning procedures are necessary to audit a nonpublic company.
- Determine the best way to obtain an understanding of the audit client and its environment.

Lesson 2—Understanding Internal Control, Entity-level Controls, and Activity-level Controls

Completion of this lesson will enable you to:
- Determine how to obtain an understanding of the audit client's internal control.
- Recognize how to obtain an understanding of the audit client's entity-level controls.
- Identify and obtain an understanding of the audit client's activity-level controls.

Lesson 3—Planning Decisions and Judgments, Fraud, Laws and Regulations, and the Audit Time Estimate

Completion of this lesson will enable you to:
- Identify the planning decisions and judgments that an auditor must make when auditing a nonpublic company.
- Determine the auditor's responsibilities related to fraud, laws, and regulations when auditing a nonpublic company and recognize how to plan an appropriate audit time estimate.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com**/**ogs.** Online grading allows you to get instant CPE credit for your exam.

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Lesson 1: Risk Assessment, Other Planning Procedures, and Understanding the Entity and Its Environment

INTRODUCTION

This course explains the start of an annual audit in a continuing engagement. While the same suggested approach can be used for a new engagement, additional procedures would also be necessary. This course focuses on continuing engagements, so new engagements are outside of its scope. More information on new engagements can be found in *PPC's Guide to Audits of Nonpublic Companies.*

The focus of this course is *general* planning decisions. General or preliminary planning can be distinguished from detailed planning of audit programs. Preliminary planning includes deciding on an overall strategy for the audit, obtaining an understanding of the entity and its environment, including its internal control, making an initial assessment of audit risk and materiality, and deciding on the overall timing of the engagement.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize what risk assessment and other planning procedures are necessary to audit a nonpublic company.
- Determine the best way to obtain an understanding of the audit client and its environment.

Authoritative Literature

The following establish key requirements and provide guidance that affect preliminary audit planning:

a. AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, establishes specific quality control requirements to be performed as part of an audit.

b. AU-C 230, *Audit Documentation*, addresses the auditor's responsibility to prepare audit documentation for an audit of financial statements. These requirements apply to documentation of risk assessment procedures as well as to all other audit procedures.

c. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud and determining the overall and specific responses to those risks.

d. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for obtaining an understanding of the legal and regulatory framework relevant to the industry or sector in which the entity operates and how the entity complies with that framework.

e. AU-C 260, *The Auditor's Communication With Those Charged With Governance*, establishes requirements for the auditor to communicate with those charged with governance.

f. AU-C 300, *Planning an Audit*, establishes requirements for audit planning, including development of an overall strategy and audit plan, involvement of the engagement partner and team members, and consideration of whether specialized skills are needed.

g. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements for performing risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement and requires obtaining an understanding of various specific matters, including the aspects of internal control relevant to the audit.

h. AU-C 320, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality for the financial statements as a whole and performance materiality as a basis for assessing the

risks of material misstatement at the assertion level, and determining the nature, timing, and extent of further audit procedures.

i. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establishes requirements for determining the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.

j. AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance on obtaining an understanding of internal control of a client that uses a service organization.

k. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements relating to auditing accounting estimates.

l. AU-C 550, *Related Parties*, establishes specific additional audit requirements regarding related party relationships and transactions.

m. AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes requirements for considering whether conditions or events exist that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

n. AU-C 610, *Using the Work of Internal Auditors*, provides guidance on (a) using the work of the internal audit function and (b) using internal auditors for direct assistance in the audit of financial statements.

The use of analytical procedures in audit planning is included in AU-C 315. AU-C 520, *Analytical Procedures*, addresses the use of analytical procedures as substantive procedures and near the end of the audit, which is beyond the scope of this course. More information about substantive procedures is available in *PPC's Guide to Audits of Nonpublic Companies*.

Objectives and Requirements

Objectives. The objectives of the auditor when planning the audit and performing risk assessment procedures are as follows:

- To plan the audit in such a manner that it will be performed effectively.
- To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, at the financial statement and relevant assertion levels by understanding the entity and its environment, including internal control, as a basis for designing and implementing responses to the assessed risks of material misstatement.
- To obtain an understanding of relationships and transactions with related parties that is adequate to recognize fraud risk factors relevant to the identification and assessment of risks of material misstatement due to fraud.
- To obtain an understanding of the nature and significance of services provided by a service organization, if the entity uses one, and the effect of those services on the user entity's internal control relevant to the audit, sufficient to identify and assess risks of material misstatement.
- To communicate clearly with those charged with governance the auditor's responsibilities and an overview of the planned scope and timing of the audit.
- To properly apply the materiality concept in the planning and performance of the audit.

Requirements. The requirements that should be followed to achieve those objectives are summarized in Exhibit 1-1.

Exhibit 1-1

Requirements Related to Risk Assessment Procedures and Planning

Requirements	AU-C Reference
Planning an Audit	
Involve the engagement partner and other key engagement team members in the engagement team's discussion and other audit planning activities.	AU-C 300.05
Establish an overall audit strategy by— • Identifying the key characteristics that define the scope of the engagement. • Determining the reporting objectives to properly plan the timing of the audit and the required communications. • Considering the significant factors that impact the engagement team's efforts. • Considering the results of preliminary engagement activities and, if applicable, knowledge from other engagements performed by the engagement partner for the entity. • Determining the nature, timing, and extent of resources needed to perform the audit.	AU-C 300.07 AU-C 300.08
Update and modify the overall audit strategy and audit plan, as necessary, throughout the engagement.	AU-C 300.10
Plan the nature, timing, and extent of how engagement team members will be directed and supervised and how their work will be reviewed.	AU-C 300.11
Document the overall audit strategy, the audit plan, any significant changes made during the engagement to the audit strategy or the audit plan, and the reasons for those changes.	AU-C 300.14
Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	
Understanding the Entity and Its Environment	
Perform risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement at both the financial statement and relevant assertion levels, including inquiries of management, appropriate individuals from internal audit (if the entity has an internal audit function), and others within the entity that may have relevant information, analytical procedures, and observation and inspection.	AU-C 315.05 AU-C 315.06
Consider the relevance of information obtained during client acceptance or continuance when identifying risks of material misstatement.	AU-C 315.07
If the engagement partner has performed other engagements for the entity, consider whether that information is relevant to identifying risks of material misstatement.	AU-C 315.08
Consider the assessed risk of material misstatement due to fraud along with other information obtained.	AU-C 315.09
When intending to use information from previous experience with the entity or audit procedures performed in previous audits, determine whether changes have occurred that affect its continued relevance.	AU-C 315.10
Discuss (among the engagement partner and other key engagement team members) the susceptibility of the financial statements to material misstatement and the application of GAAP to the entity's facts and circumstances. For the engagement partner (or equivalent), determine which matters to communicate to engagement team members not involved in the discussion.	AU-C 315.11

Requirements	AU-C Reference
Obtain an understanding of— • Relevant industry, regulatory, and other external factors. • The nature of the entity, including its operations, its ownership and governance structures, its existing and planned investments (including investments in entities formed to achieve specific objectives), and its structure and financing to understand the classes of transactions, account balances, and disclosures expected in the financial statements. • The entity's selection and application of accounting policies and reasons for any changes. • The entity's objectives and strategies and the related business risks that may relate to risks of material misstatement. • How the entity measures and reviews its financial performance.	AU-C 315.12
Evaluate the appropriateness of the entity's accounting policies for its business and assess whether they are consistent with GAAP and policies used in the relevant industry.	AU-C 315.12
Obtain an understanding of internal control relevant to the audit and evaluate the design of those controls. Perform inquiry and other procedures to determine whether the controls have been implemented.	AU-C 315.13 AU-C 315.14
Obtain an understanding of the control environment and evaluate whether management and those charged with governance have created and maintained a culture of honesty and ethical behavior. Also evaluate whether the control environment elements collectively provide support for the other components of internal control and whether those other components are undermined by deficiencies in the control environment.	AU-C 315.15
Obtain an understanding of whether the entity has a process for identifying and estimating the significance of business risks related to financial reporting objectives, assessing the likelihood of their occurrence, and determining actions to address those risks.	AU-C 315.16
Obtain an understanding of the entity's risk assessment process, if one has been established, and its results. If risks of material misstatement are identified that management failed to identify, evaluate whether an underlying risk existed that the entity's risk assessment process was expected to identify. If such a risk exists, understand why that process failed to identify the risk, evaluate whether the process is appropriate to its circumstances, or determine if a significant deficiency or material weakness exists in internal control for the entity's risk assessment process.	AU-C 315.17
If a risk assessment process has not been established or it is only an ad hoc process, ask management if business risks that apply to financial reporting objectives have been identified and, if so, how they were addressed. In addition, evaluate whether the lack of a documented process is appropriate for the entity or determine whether it represents a significant deficiency or material weakness in internal control.	AU-C 315.18

Requirements	AU-C Reference
Obtain an understanding of the information system and the related processes relevant to financial reporting, including: • The classes of transactions that are significant to the financial statements. • The automated and/or manual procedures that initiate, authorize, record, process, correct as necessary, transfer to the general ledger, and report those transactions in the financial statements. • The manual or electronic accounting records that support information and specific accounts in the financial statements and are used to initiate, authorize, record, process, and report transactions. • How significant events and conditions other than transactions are captured in the system. • How the financial statements, including significant accounting estimates and disclosures, are prepared. • The controls over standard and nonstandard journal entries.	AU-C 315.19
Obtain an understanding of how financial reporting roles and responsibilities and significant matters relating to financial reporting are communicated, including communications between management and those charged with governance and external communications.	AU-C 315.20
Obtain an understanding of control activities relevant to the audit, including how detailed records for material account balances are reconciled to the general ledger.	AU-C 315.21
Obtain an understanding of how the entity has responded to IT-related risks.	AU-C 315.22
Obtain an understanding of how the entity monitors internal control over financial reporting, including monitoring the control activities relevant to the audit, and how the entity takes action to correct any deficiencies in controls.	AU-C 315.23
If the entity has an internal audit function, obtain an understanding of the nature of its responsibilities, how it fits in the entity's organizational structure, and the activities it has performed or will perform.	AU-C 315.24
Obtain an understanding of the sources of the information used for monitoring activities and why management considers that information to be sufficiently reliable.	AU-C 315.25
Assessing Risks of Material Misstatement	
If a significant risk exists, obtain an understanding of the manual or automated controls related to that risk and, based on that understanding, evaluate whether the controls are suitably designed and implemented to mitigate such risks.	AU-C 315.30
For risks judged as risks for which it is not possible or practicable to obtain sufficient appropriate evidence only from substantive procedures, obtain an understanding of the controls over such risks relevant to the audit.	AU-C 315.31
Document the following: • Discussion among the engagement team including the significant decisions reached, how and when the discussion occurred, and the audit team members who participated. • Key elements of the understanding obtained for each aspect of the entity and its environment and each internal control component, the sources of information, and the risk assessment procedures performed. • Identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level. • Significant risks and risks for which substantive procedures alone are not sufficient and the understanding obtained of the related controls.	AU-C 315.33

Requirements	AU-C Reference
Materiality in Planning and Performing an Audit	
Determine materiality for the financial statements as a whole. Also, determine a lesser materiality level(s) to apply to specific classes of transactions, account balances, or disclosures if misstatements of lesser amounts could reasonably be expected to affect the economic decisions of the users of the financial statements.	AU-C 320.10
Determine performance materiality to be used to assess the risks of material misstatement and determine the nature, timing, and extent of further audit procedures.	AU-C 320.11
Revise materiality for the financial statements as a whole if information is identified during the audit that would have caused a different amount to be determined initially. If applicable, revisions may also be necessary for the lesser materiality amount(s) for specific classes of transactions, account balances, or disclosures.	AU-C 320.12
If the revised materiality is lower than the initially determined amount, determine whether a revision of performance materiality is necessary and whether the nature, timing, and extent of further procedures are still appropriate.	AU-C 320.13
Document the following amounts and the factors considered in determining those amounts: materiality for the financial statements as a whole; if applicable, the materiality level(s) of lesser amount(s) for specific classes of transactions, account balances, or disclosures; performance materiality; and any revisions during the audit to the preceding amounts.	AU-C 320.14
Consideration of Fraud in a Financial Statement Audit	
Maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist.	AU-C 240.12
Unless there is a reason to believe otherwise, accept client records and documents as genuine. If conditions cause a belief that a document may not be authentic or that terms in a document have been modified but not disclosed, investigate further.	AU-C 240.13
When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), investigate the inconsistencies or unsatisfactory responses further.	AU-C 240.14
Have a discussion among the key engagement team members, including the engagement partner, about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. Set aside the belief that management and those charged with governance are honest and have integrity and discuss the following: • Known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for the perpetration of fraud, and indicate a culture or environment enabling management or others to rationalize committing fraud. • The risk of management override of controls. • Consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting. • The importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud. • How the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.	AU-C 240.15

Requirements	AU-C Reference
Continue the communication among the engagement team members about the risks of material misstatement due to fraud throughout the audit.	AU-C 240.15
When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, perform procedures to obtain information for use in identifying the risks of material misstatement due to fraud.	AU-C 240.16
Make inquiries of management regarding their— • Assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent, and frequency of their assessments. • Process for identifying, responding to, and monitoring the risks of fraud, including any specific risks of fraud that they have identified or that have been brought to their attention; or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist. • Communication, if any, to those charged with governance regarding the processes for identifying and responding to the risks of fraud. • Communication, if any, to employees regarding management's views on business practices and ethical behavior.	AU-C 240.17
Make inquiries of management and others within the entity to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity.	AU-C 240.18
Make inquiries of internal audit, if an internal audit function exists, to obtain their views about the risks of fraud and to determine whether they have knowledge of any actual, suspected, or alleged fraud; whether they have performed any procedures to identify or detect fraud during the year; and whether management has satisfactorily responded to any findings resulting from those procedures.	AU-C 240.19
Unless all of those charged with governance are involved in managing the entity, obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate those risks.	AU-C 240.20
Unless all of those charged with governance are involved in managing the entity, make inquiries of those charged with governance (or the audit committee or, at least, its chair) to determine their views about the risks of fraud and whether they have knowledge of any actual, suspected, or alleged fraud.	AU-C 240.21
Evaluate whether unusual or unexpected relationships identified during analytical procedures performed as part of risk assessment indicate risks of material misstatement due to fraud. Those analytical procedures, and evaluation thereof, should include analytical procedures relating to revenue accounts.	AU-C 240.22
Consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.	AU-C 240.23
Evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present.	AU-C 240.24
Identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.	AU-C 240.25
Treat assessed risks of material misstatement due to fraud as significant risks and obtain an understanding of the entity's related controls, including control activities, relevant to such fraud risks. The understanding should include an evaluation of whether those controls have been suitably designed and implemented to mitigate the fraud risks.	AU-C 240.27

Requirements	AU-C Reference
Determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. In determining overall responses— • Assign and supervise personnel, taking into account the knowledge, skill, and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud. • Evaluate whether the entity's selection and application of accounting policies, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings, or a bias that may create a material misstatement. • Incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures.	AU-C 240.28 AU-C 240.29
Document the following: • The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, how and when the discussion occurred, and the audit team members who participated. • The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.	AU-C 240.43
Document the following as part of the auditor's responses to the assessed risks of material misstatement: • The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing, and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level. • The results of the audit procedures, including those designed to address the risk of management override of controls.	AU-C 240.44
Document how the presumption that improper revenue recognition is a fraud risk was overcome, if applicable.	AU-C 240.46
Designing and Implementing Responses to Assessed Risks	
Design and implement overall responses to address risks of material misstatement at the financial statement level.	AU-C 330.05
Consideration of Laws and Regulations in an Audit of the Financial Statements	
As part of obtaining an understanding of the entity and its environment, obtain a general understanding of the entity's legal and regulatory framework and the industry or sector in which the entity operates, and how the entity is complying with the framework.	AU-C 250.12
Inquire of management and those charged with governance about whether the entity is in compliance with laws and regulations and inspect correspondence with relevant licensing or regulatory authorities, if any.	AU-C 250.14

Requirements	AU-C Reference
Auditing Accounting Estimates	
Obtain an understanding of the following relating to accounting estimates: • Requirements of GAAP relevant to accounting estimates, including disclosures. • How management identifies transactions, events, and conditions that may give rise to new accounting estimates. In obtaining this understanding, make inquiries of management about changes in circumstances that could affect accounting estimates. • How management makes accounting estimates and the data on which the estimates are based, including— •• Methods used, including models. •• Relevant controls. •• Whether a specialist has been used. •• Assumptions underlying estimates. •• Whether there has been, or ought to have been, a change from the prior period in methods or assumptions and, if so, why. •• Whether estimation uncertainty has been assessed by management and, if so, how.	AU-C 540.08
Review the outcome of accounting estimates made for prior-period financial statements, or, if applicable, subsequent re-estimation for the current period.	AU-C 540.09
Related Parties	
In connection with the engagement team discussion, include specific consideration of the susceptibility of the financial statements to material misstatement that could result from related party relationships and transactions.	AU-C 550.13
Inquire of management about— • Identity of related parties, including changes from the prior period. • Nature of the related party relationships. • Whether the entity has entered into transactions with related parties during the period and, if so, the type and purpose of the transactions.	AU-C 550.14
Inquire of management and others and perform risk assessment procedures to obtain an understanding of controls established to— • Identify, account for, and disclose related party relationships and transactions. • Authorize and approve significant transactions and arrangements with related parties. • Authorize and approve significant transactions and arrangements outside the normal course of business.	AU-C 550.15
If fraud risk factors regarding related parties are identified, consider the information in assessing risks of material misstatement due to fraud.	AU-C 550.20
Going Concern Uncertainties	
When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, consider if there are conditions or events (considered in the aggregate) that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	AU-C 570.12

Requirements	AU-C Reference
As part of the performance of risk assessment procedures, determine if management has performed a preliminary evaluation of whether conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time exist: • If so, discuss the evaluation with management and determine if conditions or events have been identified and, if so, understand management's plans to address such matters. • If not, discuss with management the basis for the planned use of the going concern basis of accounting and if conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	AU-C 570.12
Remain alert throughout the audit for any evidence of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.	AU-C 570.13
Service Organizations	
Obtain an understanding of how the entity uses the services of a service organization, including the nature and significance of the services provided, nature and materiality of the transactions processed or accounts or financial reporting processes affected, degree of interaction between the activities of the service organization and those of the user entity, and nature of the relationship between the user entity and the service organization, including relevant contractual terms.	AU-C 402.09
Inquire of management about whether a service organization has reported to them, or whether they are otherwise aware of, any fraud, noncompliance with laws and regulations, or uncorrected misstatements affecting the financial statements of the user entity and evaluate how such matters, if any, affect the nature, timing, and extent of further audit procedures, including the effect on the user auditor's conclusions and report.	AU-C 402.19
Quality Control for an Engagement Conducted in Accordance with GAAS	
For the engagement partner, take responsibility for the direction, supervision, and performance of the audit engagement.	AU-C 220.17
The Auditor's Communication with Those Charged with Governance	
Communicate with those charged with governance an overview of the planned scope and timing of the audit.	AU-C 260.11

* * *

Nature of Audit Planning

Planning an audit, according to AU-C 300.02, involves establishing the overall strategy for the engagement and developing an audit plan. Audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope, timing, and direction. It includes matters such as identifying material locations and account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

Auditors generally establish a preliminary audit strategy before performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of their preliminary engagement activities. As auditors gather additional information through the performance of risk assessment procedures, they complete the overall audit strategy, including overall responses at the financial statement level.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. An effectively planned audit is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. The objective of the auditor, according to AU-C 315.03, is to identify and assess the risks of material misstatement (either due to fraud or error) at both the financial statement and relevant assertion levels by understanding the entity and its environment (including its internal control) to provide a basis for the design and implementation of responses to such risks.

Audit planning also includes developing an audit plan (also called an audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence.

The nature, timing and extent of audit planning varies with the size and complexity of the entity and with the auditor's understanding of the entity and its environment, including internal control. However, audit planning always includes a risk assessment process.

The Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on the understanding. It may be useful to classify the audit planning requirements in the following categories:

- Procedures performed.
- Understanding obtained.
- Decisions and judgments made.

Each of these categories is discussed in more detail later in this lesson.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, including preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor performs all of these procedures when planning the audit.

The auditor's consideration of fraud in accordance with AU-C 240 is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. The key requirements of AU-C 240 are addressed at relevant points throughout this course.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control. The auditor obtains information about the following:

a. Industry, regulatory, and other external factors.

b. Nature of the entity.

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

d. Measurement and review of the entity's financial performance.

e. Internal control, which includes the selection and application of accounting policies.

f. Fraud risk factors.

Decisions and Judgments Made. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement at the financial statement and relevant assertion levels.

Summary of Risk Assessment Process. Exhibit 1-2 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

Exhibit 1-2

The Risk Assessment Process

Procedures Performed	Understanding Obtained	Decisions and Judgments Made
• Preliminary engagement activities. • Inquiries of management and others. • Preliminary analytical procedures. • Observation and inspection. • Discussion among the engagement team.	• Industry, regulatory, and other external factors. • Nature of the entity. • Objectives, strategies, and related business risks. • Measurement and review of the entity's financial performance. • Internal control. • Selection and application of accounting policies. • Fraud risk factors.	Decisions at the Financial Statement Level: • Materiality at the financial statement level. • Materiality for particular items of lesser amounts. • Risks of material misstatement at the financial statement level. • Overall audit strategy. Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level: • Performance materiality. • Risks of material misstatement at the relevant assertion level, including identification of significant risks. • Nature, timing, and extent of further audit procedures (including tests of controls and substantive procedures).

* * *

The Sequence of Audit Planning

Because an audit of financial statements is an iterative process, audit planning is not a discrete phase of the audit. Audit planning continues throughout the audit even though many of the planning steps and procedures necessarily are performed at the beginning of the audit process. Audit planning begins with engagement acceptance and continues throughout the remainder of the audit. Also, many of the audit planning steps and procedures can be performed simultaneously and tend to blend together. Nevertheless, having a logical sequence of steps and procedures provides a useful framework. The approach used in this course is presented in Exhibit 1-3.

Depending on the auditor's knowledge and past experience with the client, as well as other factors, certain planning steps might be performed at differing stages or sequences from one engagement to the next. For example, the sixth step, determine the materiality level for the financial statements taken as a whole, and the twelfth step, determine performance materiality, are often performed concurrently. Also, some auditors might choose to determine materiality (step 6) before performing risk assessment procedures (step 5) to help determine the areas of focus. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances. It is usually more efficient and effective if it occurs relatively early in planning, but it need not occur in any particular sequence. Although planning steps may occur in a slightly different sequence than illustrated in Exhibit 1-3, it is important that the auditor revisit judgments made earlier in planning as new information becomes available throughout the audit to determine the effect on risk identification, risk assessment, materiality, and further audit procedures.

Exhibit 1-3

Steps in the Audit Process Related to Planning

Preliminary Engagement Activities

1. Perform procedures regarding acceptance or continuance of the client relationship and the specific audit engagement.
2. Evaluate compliance with ethical requirements, including independence.
3. Establish an understanding with the client and communicate in an engagement letter.

General Audit Planning at the Financial Statement Level

4. Establish preliminary audit strategy.
5. Determine the nature, timing, and extent of risk assessment procedures and perform the procedures.
6. Determine the materiality level for the financial statements taken as a whole (preliminary planning materiality) and materiality for particular items of lesser amounts.
7. Perform preliminary analytical procedures (a risk assessment procedure).
8. Hold a discussion among the engagement team.
9. Identify fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks of material misstatement.
10. Assess audit risk at the overall financial statement level.
11. Complete the overall audit strategy, including overall responses at the financial statement level.

Detailed Audit Planning at the Relevant Assertion Level for Account Balances, Transaction Classes, and Disclosures

12. Determine performance materiality (often in conjunction with Step 6).
13. Assess audit risk in relation to relevant assertions for transactions classes, account balances, and disclosures.
14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

* * *

Organization of This Course

This course focuses on those portions of the risk assessment process relating to general audit planning, the performance of risk assessment procedures, and the determination of the overall audit strategy. The concepts previously introduced in this section—the risk assessment procedures, the understanding of the entity and its environment, and certain of the decisions and judgments made by the auditor—are discussed in greater depth in the following sections. Even though performance materiality is applied at the account balance and transaction class level rather than at the financial statement level, it is also addressed in this course because it is often determined concurrently with planning materiality. Specifically, this course addresses steps 4 through 12 in Exhibit 1-3. In-depth discussion of steps 1 through 3, preliminary engagement activities; steps 13 and 14, detailed audit planning in relation to relevant assertions for transaction classes, account balances, and disclosures; and the evaluation of audit findings are beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Nonpublic Companies.*

The organization of this course is as follows:

Lesson 1

- Risk assessment and other planning procedures.
- The understanding of entity and its environment (excluding internal control).

Lesson 2

- The general requirements for obtaining an understanding of internal control along with a suggested approach.
- Obtaining an understanding of entity-level controls, including the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring. The section also discusses the IT environment and general IT controls.
- Obtaining an understanding of activity-level controls, including the financial reporting system, and control activities.

Lesson 3

- The planning decisions and judgments made by the auditor culminating in the overall audit strategy.
- The auditor's consideration of fraud and how it relates to the overall risk assessment process.
- The auditor's consideration of laws and regulations and how it relates to the overall risk assessment process.
- Planning the audit time estimate and documenting the time spent performing the audit.

RISK ASSESSMENT PROCEDURES, AS WELL AS OTHER PLANNING PROCEDURES

AU-C 315.05 explains that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels. Risk assessment procedures are focused toward gathering and evaluating information about the client and are not specifically designed as tests of controls or substantive procedures. Risk assessment procedures alone do not provide sufficient appropriate audit evidence on which to base an opinion. In all circumstances, further audit procedures are necessary to support an opinion.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as *risk assessment procedures* because the information obtained by performing those procedures is used to support the auditor's assessment of the risk of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. A variety of risk assessment procedures are used when obtaining an understanding of the entity and its environment. For example, an auditor cannot limit his or her risk assessment procedures to only inquiry.

In addition to providing information about the entity and its environment, including its internal control, the performance of risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures. However, as mentioned above, risk assessment procedures by themselves do not provide sufficient appropriate audit evidence to express an opinion on financial statements.

Types of Risk Assessment Procedures

AU-C 300 and 315 specifically identify the following audit procedures and related activities as necessary risk assessment and other planning procedures:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of management, internal audit (if applicable), and others within the entity and those charged with governance.

c. Analytical procedures.

d. Observation and inspection. [Examples of such procedures include visits to the entity's premises and tracing transactions through the information system (that is, walkthroughs).]

e. Discussion among the engagement team.

All of the risk assessment procedures are performed when obtaining an understanding of the entity and its environment. However, each of those procedures need not be performed for every component of the understanding outlined later in this lesson. Nevertheless, the standards are explicit in indicating that inquiry alone is not sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement is required by AU-C 315.11, and AU-C 240.15 expands on the discussion as it relates to brainstorming about susceptibility to material misstatement due to fraud.

Nature, Timing, and Extent—General Considerations. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will need tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management responsible for financial reporting about accounting policies and other aspects of the financial reporting process. However, determining others within the entity to whom related questions may be directed will depend on the circumstances and the specific information gathered about the entity. For example, if initial inquiries reveal that customer contract terms are complex, the auditor will likely make further inquiries of sales and marketing personnel about contractual arrangements with customers and may also make related inquiries of in-house legal counsel. Thus, performance of risk assessment procedures often can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after some information is gathered about the entity and its environment.

Gathering Information Needed to Identify Fraud Risks. In connection with obtaining an understanding of the company's business and the industry in which it operates, auditors may become aware of information that is relevant to identifying fraud risks. AU-C 240.17–.24 explains that auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management and others in the company about the risks of fraud and how they are addressed.
- Consider the results of analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Since professional standards require the performance of risk assessment procedures to obtain an understanding of the entity and provide a basis for the assessment of risks, can the auditor use information gathered from procedures performed in a prior period and limit the extent of current year procedures? Similarly, can information obtained from the auditor's previous experience with the client (for example, a review engagement performed in the previous year) be used in identifying risks of material misstatement? The answer to both questions is a qualified "yes."

The process of understanding the client's business and industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor's previous experience with the entity contributes to the understanding of the entity and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The entity's organizational structure, business, controls, and operations.
- Past misstatements and whether they were corrected on a timely basis.
- Significant changes from the prior period.

Information about past misstatements assists the auditor in assessing risks of material misstatement in the current audit. Before using information obtained in prior periods, however, AU-C 315.10 requires auditors to ascertain whether changes have occurred since the last audit that may be relevant in the current audit. The auditor is interested in identifying changes in personnel; procedures; processes; contracts; products or services; contingencies; facilities; nature of the business; ownership; management; financial condition; earnings pressures; conditions and events or operating results that are relevant to the going concern assumption; loan covenant compliance; litigation status; control environment or activities; fraud risks; management attitude toward, or pressures on, the auditors; scope of the engagement; and any other internal or external conditions that might be of audit significance. These changes may change the client's business risk or the auditor's assessment of risks of material misstatement. Therefore, the auditor performs risk assessment procedures in the current audit to determine whether changes have occurred that impact the relevance of information gathered in previous audits. For example, auditors might perform inquiries of client management and key client personnel, including accounting personnel outside the accounting department or other parties, supplemented by observation and inspection (for example, review of interim financial reports and budgets and walkthroughs) to determine if changes have occurred.

Paragraph 3.132 of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide) specifically notes that the nature, timing, and extent of procedures performed to update the understanding of the client obtained in prior periods may depend on matters such as—

- Significance of the changes to the entity or its environment that have occurred from the prior period.
- Relative significance of the risks of material misstatement that may be affected by changes.
- Reliability of evidence available to support conclusions about any changes from the prior period.

Although the nature of the auditor's procedures always includes inquiries, observation, and inspection, the extent of risk assessment procedures may be considerably less in continuing audit engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes. The extent of current period risk assessment procedures may need to be increased, however, in response to the following:

- The information relates directly to a past misstatement or risk of material misstatement identified in the prior year.
- Other information obtained through risk assessment procedures indicates a possible significant change in the current year.
- There is a greater likelihood that significant changes will occur given the nature of the information.

The following paragraphs address the risk assessment procedures listed in the "Types of Risk Assessment Procedures" paragraph and their role in identifying and assessing risk.

Inquiries of Management and Others

Inquiry of management and others is used extensively throughout the audit planning process. AU-C 315.06 specifically requires the auditor to make inquiries of management, internal audit (if such a function exists), and

others within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud. In many cases, inquiry serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures. Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed. As such, inquiry can be an extremely effective procedure in identifying risks. For example, an auditor might ask management about the level of technology for the entity's products as compared to the industry. The auditor would then evaluate the response obtained and determine if a potential risk exists. In this case, the auditor is concerned about potential inventory obsolescence and, if so, a possible writedown. If the auditor deems that there is an indication of this risk, additional inquiries might be posed to further identify the risk and determine whether other lrisk assessment procedures are necessary.

Although inquiry is a critical risk assessment procedure, inquiry cannot be used alone when identifying and assessing risks. As noted above, auditors use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, as discussed in Lesson 2, auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.

Matters and Parties of Inquiry. Auditing standards require the auditor to inquire of management and others in the entity about the following matters relevant to audit planning:

a. The entity and its environment as enumerated in AU-C 315 and explained later in this lesson and in Lesson 2.

b. Fraud-related matters as enumerated in AU-C 240 and discussed later in this lesson and in Lesson 3.

c. Related parties and related party transactions as enumerated in AU-C 550 and discussed later in this lesson.

d. Accounting estimates as enumerated in AU-C 540 and discussed later in this lesson.

e. Compliance with laws and regulations as enumerated in AU-C 250 and discussed later in this lesson.

f. Communications from service organizations about fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the entity's financial statements, as enumerated in AU-C 402.19 and discussed later in this lesson.

g. Management's preliminary evaluation of whether conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, as enumerated in AU-C 570 and discussed later in this lesson.

Examples of the members of management that auditors may consider interviewing include:

- The owner/manager in a small business.
- The president or chief executive officer.
- The controller.
- The chief financial officer.
- Component management (if applicable).

In addition to inquiries of management and those charged with governance, inquiries of others within and outside the entity are either required or can provide useful information. Examples of inquiries of others include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how financial statements are used. AU-C 240.21 requires the auditor to inquire directly of those charged with governance

(or the audit committee or at least its chair) about the risks of fraud and their knowledge of actual, suspected, or alleged fraud.

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function. AU-C 315.06 requires inquiries of appropriate internal audit personnel who may have information on risks of material misstatement due to fraud or error, or who can assist in identifying such risks. AU-C 240.19 requires inquiry of internal audit personnel about risks of fraud, knowledge of actual, suspected, or alleged fraud, and activities concerning fraud detection, and whether management satisfactorily responded to any findings.

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. AU-C 240.A18–.A19 and AU-C 315.A7 include discussions of the benefits of inquiry and provides examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud. Auditors may consider obtaining the perspective of employees from different functional areas and at varying levels of authority when identifying risks of material misstatement. Examples of inquiries that may be made of other employees include:

   (1) *Financial Reporting Personnel.* Appropriateness of the selection and application of accounting policies, including the initiation, authorization, processing, or recording of complex or unusual transactions. AU-C 240.32 explicitly requires inquiries about knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

   (2) *In-house Legal Counsel.* Litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contract terms.

   (3) *Marketing, Sales, or Production Personnel.* Changes in marketing strategies, sales trends, production strategies, or contractual arrangements with customers.

   (4) *IT Systems Personnel or Users.* Their role in identifying changes to IT systems, how frequently changes occur, effectiveness of application and access controls, and excessive system downtime and other functional issues.

   (5) *Risk Management Personnel.* Information about operating, regulatory, and other risks that may affect financial reporting.

d. *Parties Outside the Entity.* Inquiries of parties outside the entity are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of external legal counsel or of valuation experts that management has engaged. The auditor might also find it useful to make inquiries of customers, suppliers, or regulators to better understand the nature of the entity and its operations.

When deciding which individuals within the entity to make inquiries of, it may be helpful to consider—

- Employees who may have additional knowledge of matters identified in discussions with management or those charged with governance, or during the engagement team discussion.
- Employees who may be able to corroborate information received from management or others.
- Employees who may offer a unique or different perspective about the risks of material misstatement due to their background, tenure, etc.
- Employees who might provide information about the possibility of management override of controls.

In addition to those parties identified above, examples of the types of individuals within the entity that auditors may consider interviewing include—

- Employees at varying levels of authority within the entity, from low-level clerical employees to senior management, including employees the auditor comes in contact with while obtaining an understanding

of internal control, observing inventory, or obtaining explanations for significant differences or fluctuations arising from analytical procedures.

- Employees outside the accounting department.
- Operating personnel.
- Employees involved in recording or processing journal entries.
- Employees involved in initiating, recording, or processing complex or unusual transactions.
- Employees in areas identified as vulnerable to the risk of fraud or error during the engagement team discussion.
- Employees with key roles in internal control.
- Employees referred to by other interviewees.

Fraud-related Inquiries. The consideration of fraud in a financial statement audit is an integral part of obtaining an understanding of the entity and its environment and assessing the risks of material misstatement. AU-C 315.09 explains that during planning the auditor should consider the results of the fraud risk assessment along with the other information obtained as part of identifying the risks of material misstatements. AU-C 240.15 notes that the discussion among the engagement team required by AU-C 315 should include fraud brainstorming, and AU-C 315.29 also notes that the auditor should consider fraud risks in identifying significant risks. The inquiries of management made in audit planning, according to AU-C 240.17–.18, should include the following specific areas of inquiry:

- Whether they have knowledge of any actual, suspected, or alleged fraud.
- Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.
- The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.
- Any specific risks of fraud that management has identified or that have been brought to its attention.
- The classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.
- Management's communications, if any, to:
  - Those charged with governance on its process for identifying and responding to fraud risks.
  - Employees on its views on appropriate business practices and ethical behavior.

The areas of inquiry required by AU-C 240 include management's processes and assessment methods, as well as knowledge of identified risks or actual, suspected, or alleged fraud. Naturally, auditors give more weight to information about risks and knowledge of fraud if management has effective processes and assessment methods. However, AU-C 240.A20 also notes that management is often best-situated to perpetrate fraud. Thus, the responses of members of senior management concerning the likelihood of perpetration of fraud by them are far less meaningful than responses with respect to perpetration by lower levels within the entity.

Exhibit 1-4 presents a list of questions about fraud the auditor might consider asking management or the owner/manager.

Exhibit 1-4

Inquiries about Fraud Risks for Management or the Owner/Manager

Recommended Areas of Inquiry	Possible Questions
Knowledge of any actual fraud or suspicions of fraud affecting the entity.	• Are you aware of any actual instances of fraud within the company? • Do you have any reason to suspect fraud may be occurring within the company? If so, where and how? • Have you seen any changes in employee behavior?
Awareness of any allegations of fraud or suspected fraud affecting the company.	• Have you received any communications from employees, former employees, regulators, or others alleging fraud?
Frequency and ways they assess the risk that the entity's financial statements might be materially misstated due to fraud and the controls in place to prevent and detect it.	• What is your process (how, to what extent, and how often) for assessing the risk that the entity's financial statements might be materially misstated due to fraud? • What is your process (how, to what extent, and how often) for assessing the controls in place to prevent and detect fraud? • What incentives or pressures exist to commit fraud? • What opportunities are available for fraud to be carried out? • Are you aware of any attitudes (or potential rationalizations) on the part of employees that might enable them to justify fraud? • What would be the easiest way for someone to misstate the financial statements or steal assets without getting caught? • If someone were going to overstate or understate net income, how would they do it? • If someone were going to steal and cover it up, how would they do it? • Does the company use source documents that could be easily accessed and forged? • How could false entries be made to the accounting system? • What departures from GAAP are most common in your industry? What departures from GAAP are most likely at your company? • Where are the weaknesses in the company's internal controls? • Which controls can be bypassed or overridden? Are there instances where controls have been bypassed or overridden in the past? • Have there been any identified frauds that have been common in your industry? • Have there been any changes within the industry or the business that have created or changed risks of fraud?

Recommended Areas of Inquiry	Possible Questions
How they communicate to employees the importance of ethical behavior and appropriate business practices.	• What instructions do you give to employees about how they are expected to behave when conducting business? • How do you make it clear to employees that fraudulent or unethical behavior will not be tolerated?
Their processes (programs and controls) for identifying, responding to, and monitoring fraud risks, including any (1) specific fraud risks they have identified or that have been brought to their attention, or (2) classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.	• What measures have you taken to address specific risks of fraud within the company? • What controls have been implemented to prevent one person from perpetrating and concealing a fraud when segregation of duties is not possible? • What procedures are in place for initiating, approving, and processing nonroutine transactions? • How have employees who suspect fraud been told to communicate their suspicions? • Are there any other programs and controls in place to help prevent, deter, or detect fraud? • How do you monitor the company's antifraud programs and controls to make sure they are working as intended? • Which types of transactions, account balances, financial statement classifications, or company locations are most at risk for intentional misstatement or theft? • Have you identified any specific risks of fraud within the company?
The nature and extent of monitoring multiple locations or components and whether any of them have a higher level of fraud risk.	• Do fraud risks exist or are they more likely to exist in particular company locations or components? • How do you monitor the company's operating locations to reduce the likelihood of fraud occurring and going undetected?
Whether they have reported to those charged with governance about the entity's processes for identifying and responding to fraud risks.	• Have you reported to the board of directors or audit committee about how the company's internal control serves to prevent, deter, and detect material misstatements due to fraud?

* * *

AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee, or at least its chair) about their views of the risks of fraud and whether they have knowledge of any actual, suspected, or alleged instances of fraud. In addition, where applicable, AU-C 240.20 requires the auditor to obtain an understanding of the role of those charged with governance in overseeing the company's fraud risk assessment and monitoring process. (A discussion of fraud inquiry techniques is outside the scope of this course.) Also, as previously discussed, AU-C 315.06 and AU-C 240.19 require inquiries of appropriate internal audit personnel concerning risks of material misstatement (due to fraud or error) and other matters related to fraud. According to AU-C 315.A12, appropriate individuals are those whom the independent auditor concludes have appropriate knowledge, experience, and authority.

In addition to inquiries of management, those charged with governance, and internal auditors, the auditor should direct inquiries to other employees to determine whether they are aware of fraud that is occurring or have suspicions of fraudulent activity. Deciding which employees to make inquiries of and the extent of those inquiries is

a matter of professional judgment that depends primarily on whether the auditor believes those employees may provide information that is relevant to identifying fraud risks. The auditor might ask the following questions:

- Are you aware of any actual fraud within the company?
- Do you have any reason to suspect fraud is occurring within the company? If so, where and how?
- Do you have any reason to suspect your superior is committing fraud?

See Exhibit 1-5 for additional illustrative questions that might be appropriate for employees of different levels and departments. AU-C 240.32 requires that the auditor make specific inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments. These inquiries might be combined with inquiries such as those in Exhibit 1-5 during audit planning, but that the inquiries need to be followed up later by inquiries that cover the period through the end of the closing process and preparation of financial statements.

Making inquiries of employees outside the accounting department or those at varying levels of authority may be useful in providing a different perspective about the risks of fraud. Their responses may corroborate responses received from management or the owner/manager, or may provide information about the possibility of management override of controls. For example, an employee may indicate there has been an unusual change in the way transactions are processed. Inquiries of employees outside the accounting department may also provide information about the effectiveness of management's or the owner/manager's communication and support of the company's values or ethics throughout the company.

Because management or the owner/manager is often in the best position to perpetrate and conceal fraud, the need for professional skepticism in making the auditor's inquiries of management cannot be overemphasized. Generally, it is necessary to corroborate responses, especially those of management or the owner/manager. Also, additional audit evidence may be necessary to resolve any inconsistencies among responses.

Going Concern Uncertainties Inquiries. AU-C 570.12 requires that the auditor consider, when performing risk assessment procedures, whether there are aggregate conditions or events that raise doubt about the entity's ability to continue as a going concern for a reasonable period of time. As part of risk assessment procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events have been identified. If so, auditors and management should discuss management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, as well as plans to address any issues identified. If management has not yet made such an evaluation, the auditor is required to discuss with management the intended use of the going concern basis and inquire as to any existing conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. Auditors would consider management's evaluation in the risk assessment process and remain alert throughout the audit for any evidence indicating conditions or events that raise substantial doubt regarding going concern.

Related Party Inquiries. Although many related party transactions occur in the ordinary course of business, some related party relationships and transactions may give rise to higher risks of material misstatement than transactions with unrelated parties. As a result, the auditor is required to make specific inquiries of management and others regarding related parties.

AU-C 550.14 requires the auditor to inquire of management about the following:

- Identity of related parties, including changes from the prior period.
- Nature of related party relationships.
- Whether there were any transactions with those related parties during the period and, if so, the transaction types and purposes.

Exhibit 1-5

Possible Inquiries about Fraud Risk for Company Employees

Suggested Questions	Direct Inquiries to
• Do you know of anyone who is stealing from the company? • Do you suspect that anyone is stealing from the company? • Do you know of anyone in the company who is manipulating the accounts or records? • How could someone steal from the company without getting caught? • If I were to do [Indicate potential fraud.], how would I get caught? • How would you describe the company's (and/or management's) values and ethics? • What is it like to work here? How is the overall morale? • Are you upset with the company for any reason? Do you know of anyone who is? • Have you ever been asked to ignore or override a policy or procedure that is part of your job? Who asked you? • Have you ever seen another employee circumventing company policies, procedures, or controls? What explanation did they give? • Have you noticed any unusual changes in the behavior or lifestyle of management or any other employees? • Do you know of any employees who are under pressure to make ends meet financially? • How do you think this company compares with others in terms of the honesty of its employees? • Do you think your co-workers are honest? • Has anyone you work with ever asked you to do anything you thought was illegal or unethical? What would you do if someone asked you? • Have you ever been asked to enter false information in the (sales/purchasing/inventory/personnel) system or records? • Has anyone you work with ever asked you to withhold information from the auditors or alter documents or records? • Has the entity communicated how to report suspected fraud? If so, would you feel comfortable in reporting suspected fraud in this manner? Do you believe that reporting suspected fraud would not be held against you by management or others? • Is there anything else you would like to add, or anyone else we might talk to? • I have one last question. Have you yourself done anything against the company that was illegal or unethical?	All employees selected
• What factors (such as market competition or changes in technology) may threaten the company's ability to stay in business or earn a profit? • How would reporting improved financial results help the company? • What pressure is put on employees to achieve the company's financial goals, and by whom? • Have there been any recent changes in sales policies or terms offered to customers? Has a customer been offered terms at variance with company policies and established terms? • Were any large or unusual customer agreements entered into at or near the end of the year? • What types of customer complaints do you typically receive?	Sales and marketing

Suggested Questions	Direct Inquiries to
• How is management and/or the board compensated? • Has management exerted any pressure upon you or others to override, modify, or falsify compensation awards, agreements, or plans without sufficient justification and approval for the situation? • How are financial targets used to determine employees' pay or benefits? For example, do bonuses depend on revenues or reported earnings? • Has there been any significant turnover in personnel? In what departments? • Are there any recent or planned layoffs or changes in pay rates or benefit plans that have or could upset the workforce? • Have recent bonuses, raises, and promotions met employee expectations? Is there anything planned in those areas that could cause resentment among employees? • Have employees complained about work conditions, management demands or style, or other matters that could lead to pressures or incentives to commit fraud? • Have employees been punished or terminated for whistle-blowing or otherwise bringing unethical or fraudulent practices to the attention of appropriate internal or external parties?	Human resources
• How active is management in supervising the accounting department? • Does management (including senior finance executives) demonstrate an attitude of "shoot the messenger" when learning of unfavorable financial results or incidents? • What are the weaknesses in the company's internal controls? • Do any of the company's accounting policies seem inappropriate or overly aggressive? • Does management always tend to favor amounts that are on the high (low) side when developing accounting estimates, such as estimated liabilities and valuation accounts? • Does management often use materiality to justify questionable accounting practices? • Does it ever seem like the method of accounting for a transaction is more important than the transaction itself? Can you give me an example? • Does the owner/manager run personal expenses through the business? • What aspect of the company's performance is management most concerned about? • Are there any changes in procedures or improvements in controls that could easily be made, but management has chosen not to? • Have there been any unusual changes in the way transactions are processed? • Are there any third parties that have expectations about (or a stake in) the company's performance? What are their needs or expectations? • Have you ever been asked to record any journal entries that seemed unusual or lacked support? • Have you ever been asked to make false entries in the accounting records?	Accounting and finance

Suggested Questions	Direct Inquiries to
• Has the company's relationship with particular suppliers significantly changed (improved or deteriorated) in the past year? • What types of vendor complaints do you typically receive? • Do any vendors have a close or unusual relationship with management?	Purchasing
• Is there any inventory you have been told not to count? • Has there been any unusual movement of goods at or near year-end? • Have there been any unusual changes in the way customer shipments are handled? • Are there any inventories that you suspect are unjustly overvalued or no longer salable? • Have you been asked to falsify inventory count sheets or records?	Production and inventory

* * *

In addition, auditors are required by AU-C 550.15 to inquire of management and others within the entity and perform other risk assessment procedures as needed to understand the controls over related party relationships and transactions. Lesson 2 includes a discussion on obtaining an understanding of internal control.

Inquiries about Accounting Estimates. Because of the nature of accounting estimates, there can be a high degree of estimation uncertainty. AU-C 540.08 indicates that, when obtaining an understanding of how management identifies transactions, events, and conditions requiring accounting estimates, the auditor should make inquiries of management about whether any changes in circumstances have occurred that may give rise to new accounting estimates or the need to revise existing estimates. AU-C 540.A18 indicates that inquiries of management about such changes may include matters such as whether—

- The entity has entered into new types of transactions that may give rise to accounting estimates.
- Transaction terms that affect accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed as a result of changes to GAAP.
- Regulatory or other changes have occurred that may require the revision of existing accounting estimates or new estimates to be made.
- New conditions or events have occurred that may give rise to new or revised estimates.

Inquiries about Compliance with Laws and Regulations. AU-C 250.14 requires the auditor to inquire of management and those charged with governance about whether the entity is in compliance with laws and regulations that may have a material indirect effect on the financial statements and to inspect relevant correspondence with licensing and regulatory authorities. The focus of the auditor's inquiries is on laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements. However, compliance with those laws and regulations may be fundamental to the operating aspects of the entity, fundamental to an entity's ability to continue as a going concern, or necessary for the entity to avoid material penalties. Examples include compliance with an entity's operating license and with laws or regulations related to occupational safety and health, food and drug administrations, etc. The auditor may also inquire about the entity's policies and procedures regarding compliance with laws and regulations (including the prevention of noncompliance); the policies or procedures adopted for identifying, evaluating, and accounting for litigation claims; and the use of directives and periodic representations obtained from management at appropriate levels of authority concerning compliance with laws and regulations.

Inquiries Related to Service Organizations. AU-C 402.19 requires the auditor to inquire of management about whether a service organization has reported to them, or whether they are otherwise aware of, any fraud,

noncompliance with laws and regulations, or uncorrected misstatements at the service organization that affect the financial statements of the user entity. The auditor should evaluate how such matters, if any, affect the nature, timing, and extent of further audit procedures. If the auditor needs additional information to perform this evaluation, it may be necessary to ask the user entity to contact the service organization to obtain the necessary information.

Documentation. There are no specific documentation requirements for inquiries made as risk assessment procedures, but AU-C 230 provides pertinent guidance. AU-C 230.09 states that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the items or matters tested. AU-C 230.A14 suggests that, for a procedure involving inquiries of entity personnel, the auditor records the inquiries made, the dates of inquiries, and the names and job designations of the personnel. It is a best practice to document such matters when performing risk assessment inquiry procedures.

Analytical Procedures

AU-C 315.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information (for example, the relationship between revenue and square footage of selling space or volume of goods sold). AU-C 315.A15–.A16 explain that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.

Knowledge of the client and the industry or industries in which it operates is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to understand the entity's business and industry to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. For that reason, the auditor generally needs an understanding of the entity's industry and operations before performing preliminary analytical procedures. The auditor's knowledge and understanding of the client can also be improved by applying preliminary analytical procedures in audit planning. The use of particular analytical procedures is not required. The sophistication, extent, and timing of analytical procedures may vary widely, depending on the size and complexity of the client. Analytical procedures might include reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance or analysis of ratios or trends related to profitability, liquidity, solvency, and activity combined with inquiries of financial and operating management.

Other than the analytical procedures performed to comply with AU-C 240, as discussed later in this lesson, analytical procedures used in the planning stage only need to be designed to point out audit areas that may be indicative of potential risks and, thus, need special emphasis. In the audit of a small nonpublic business, simple comparisons and ratios are ordinarily effective, and the auditor normally need not make use of complex mathematical or statistical models. Depending on the facts and circumstances, analytical procedures may be limited to comparing the major account balances shown in the unadjusted general ledger with the financial statements for the prior year. For example, information acquired in prior audits may enable the auditor to make preliminary judgments about the inherent and control risks for assertions about material accounts and about the substantive procedures that would reduce detection risk to the desired low level. In that situation, the auditor would compare the unadjusted balances for this year with the adjusted balances for last year to identify assertions that may require altering the planned substantive procedures. If the client operates in a specialized industry, useful industry statistics may also be available for comparison purposes or the auditor may be able to identify some comparable entities. For larger or more complex entities, however, more sophisticated preliminary analytical procedures, such as ratio or trend analysis, may be used.

If ratio analysis is used, the auditor focuses on a few key relationships that provide an improved understanding of the financial statements and significant operating or financial changes. An efficient auditor avoids the temptation to compute every possible ratio. For example, accounts receivable turnover (net revenue ÷ average accounts receivable), days revenue in receivables (360 days ÷ accounts receivable turnover), and the ratio of accounts receivable to revenue all provide information on essentially the same relationship. Computing all of them and

comparing the ratios to the prior year and current budget is generally a waste of time. The auditor's discussions with management may help identify the ratios and relationships that management considers important in running the business.

When using interim financial information in the analytical review, the auditor needs to be aware of factors, such as seasonal trends, that might be considered in making comparisons. For example, if the auditor is using information as of the end of November and the client's business is highly seasonal with substantial activity in December, a straight annualization of interim information will not provide a meaningful comparison. Sometimes, particular accounting methods may make comparisons less meaningful. For example, if the client uses the LIFO inventory method, comparison of gross profit ratios might be improved by restoring LIFO reserves before computing the ratio. The auditor also ought to be aware of the possibility of events such as strikes or changes in production methods that influence comparability.

The auditor needs to avoid merely making mechanical computations and comparisons. The auditor ought to bring as much creativity and insight to the review as possible. Auditors might consider tailoring the procedures to the individual client by determining which trends, ratios, and relationships are most relevant given the industry and other relevant conditions.

In the audits of most small and midsize nonpublic businesses, the auditor normally has a sufficient understanding of the client and its operations to judgmentally consider the expected relationships. A precise quantification of these relationships is not necessary and is often not a cost-effective approach, especially when used in planning as a risk assessment procedure. No matter which financial relationships are selected for comparison purposes, the analytical review ought to include a knowledgeable scanning of the financial information to identify unusual changes and unexpected relationships that indicate specific areas of risk of material misstatement. For example, a material amount of other income when the auditor's inquiries have not identified any new sources of income raises a risk of overstatement.

Using Analytical Procedures When Large Audit Adjustments Are Expected. Analytical procedures may not be very useful in audit planning when several large audit adjustments are expected. In that case, auditors might consider limiting the analytical procedures used for audit planning as follows:

a. *Look at Major Fluctuations in Financial Statement Line Items or Large Account Balances.* This procedure can identify areas that may call for additional audit attention. For example, large increases in a notes payable account may mean there are new loans. Also, the auditor may identify large other income accounts that need detail testing. Auditors can concentrate on fluctuations in accounts that have not typically needed adjustments in the past.

b. *Look at Changes in Bottom Line Numbers.* Fluctuations in bottom line numbers such as net income, working capital, and stockholders' equity can identify unfavorable trends and going concern problems.

c. *Look at Ratios That Are Not Expected to Change.* Examine areas where major adjustments are not expected. For example, if the auditor does not expect major adjustments to accounts receivable, then aging statistics and turnover ratios can be calculated in the planning phase to help determine the nature and extent of testing of the allowance.

Auditors need to remember that analytical procedures ought to be used to understand important relationships in the client's financial and nonfinancial data and are not simply a mechanical exercise. Also, as noted at the beginning of this lesson, audit planning is not confined to the start of the engagement. AU-C 300.A2 observes that planning is not a discrete phase of an audit, but rather begins shortly after completion of the previous audit and continues until the completion of the current audit engagement. So analytical procedures also can be used for planning during fieldwork.

The Value of Preliminary Analytical Procedures in Risk Identification. To be effective in identifying potential risks of material misstatement, analytical procedures need to be designed to identify the absence of an expected relationship or the presence of an unexpected relationship. For example, there is normally a predictable relationship among revenue, accounts receivable, and bad debt expense based on historical patterns of the business. Also, the auditor would expect the relationship to change in predictable ways in response to known changes in

volume, product mix, customer composition, and the local economy. Therefore, a key element in the performance of preliminary analytical procedures for the purpose of identifying potential risks of material misstatement is the auditor's development of expectations about plausible relationships that are reasonably expected to exist. The expectations serve as the benchmark when comparing recorded amounts or ratios to determine unusual or unexpected changes or the absence of expected changes that might be the result of misstatements.

Unusual or unexpected relationships can be anything out of the ordinary. They are relationships, account balances, or transaction amounts that do not make sense. They may include trends and relationships that are at odds with comparable industry data. Ratios may be too unusual or too unrealistic to be believable even if the client appears to have a logical explanation. Account balances and transaction amounts may be too large or small, too high or low, or result in too much or too little of something. Exhibit 1-6 provides examples of unusual or unexpected relationships and possible risks that may exist.

Exhibit 1-6

Unusual or Unexpected Relationships and Potential Risks

Unusual or Unexpected Relationships from Preliminary Analytical Procedures	Potential Risks
Unusual financial statement relationships:	
• Increased revenues with decreased or significantly unchanged inventories.	• Improper revenue recognition. • Theft of inventory. • Inventory valuation issues. • Physical inventory observation errors.
• Decreased or significantly unchanged revenues with increased receivables.	• Uncollectible receivables.
• Decreased or significantly unchanged compensation expense with increased revenues.	• Payroll accrual recognition issues. • Improper cost allocation issues.
• Increased net income with decreased or significantly unchanged cash flows.	• Uncollectible receivables. • Going concern considerations. • Revenue or expense cutoff issues.
• Increased inventory with decreased or significantly unchanged purchases or payables to vendors.	• Inventory obsolescence. • Inventory valuation issues.
• Increased payables with decreased or significantly unchanged inventory.	• Going concern considerations. • Payable defalcation schemes. • Physical inventory observation errors. • Theft of inventory.
• Decreased fixed assets with increased rental expense.	• Issues in recording capital leases.
Unusual fluctuations or trends in account balances or ratios:	
• Unusual increases in miscellaneous income.	• Issues in classifying revenues. • Improper recognition of revenue or customer deposits.
• Unusual items of operating expense.	• Issues in expense classification. • Improper expensing of capital acquisitions. • Misappropriation of assets.

Unusual or Unexpected Relationships from Preliminary Analytical Procedures	Potential Risks
• Reductions in bad debt expense.	• Issues in estimating the allowance for doubtful accounts.
• Increasing trend in debt to equity ratios.	• Loan covenant risks. • Going concern considerations.

* * *

Well-designed preliminary analytical procedures based on appropriate expectations of plausible relationships can by very effective in identifying risks of material misstatement during the risk assessment stage of audit planning. However, because preliminary analytical procedures are ideally performed early in the planning process, the analytical procedures use information that is aggregated at a relatively high level (for example, recent interim financial statements or, if financial statements are not available, a general ledger trial balance). Information aggregated at a relatively high level is appropriate at this stage because the auditor is attempting to identify potential audit problems, not to reach a conclusion on the reasonableness of a specific balance. (However, the same analytical procedures might be appropriate for both purposes.) When analytical procedures use data aggregated at high level, as previously explained, AU-C 315.A16 notes that the results of those analytical procedures provide only broad initial indications about whether a material misstatement may exist. Accordingly, auditors need to consider the results of preliminary analytical procedures along with other information gathered in identifying the risks of material misstatement. As illustrated in Exhibit 1-6, the unusual or unexpected relationships noted through the performance of preliminary analytical procedures may provide a broad initial indication of potential risks. As a result, the auditor may determine that it is necessary to apply other risk assessment procedures to more precisely determine and identify the risks of material misstatement of the financial statements.

Preliminary analytical procedures may also identify declining trends in operations or significantly reduced liquidity or solvency that raise the issue of whether the client can continue as a going concern for a reasonable period of time. If such conditions are present, the auditor determines an appropriate audit response. The auditor should obtain additional information about management plans and other potential mitigating factors in the course of the audit. The auditor should also consider whether the potential going-concern problem creates an increased risk of management intentionally misstating the financial statements. As previously discussed, AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, specifically requires the auditor, when performing risk assessment procedures, to consider if there are aggregate conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. As part of such procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events exist.

Analytical Procedures Related to Revenue. In addition to the requirement in AU-C 315 to perform analytical procedures as part of risk assessment procedures, AU-C 240.22 requires that, to the extent they are not already included, analytical procedures should include procedures related to revenue. Auditors perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Ordinarily, comparison of current and prior-period account balances for revenue accounts are not sufficient to achieve that objective, and other types of analytical procedures are used. For example, if sales volume exceeds production capacity, that indicates fictitious revenue might have been recorded. Similarly, an analysis of revenues and customer returns by month during and after the end of the reporting period could identify a variety of schemes to overstate revenue. Excessive returns indicate the potential for undisclosed side agreements or shipping unordered goods. Other analytical procedures that may be useful in identifying unusual or unexpected relationships related to revenue include the following:

- *Analysis of Relationships between Financial and Nonfinancial Amounts.* When comparing financial and nonfinancial amounts, it may be most effective to use a base that (1) would be expected to have a reasonable relationship to revenue and (2) could not easily be manipulated by management or the owner/manager. For example, auditors may compare sales volume, as determined from recorded revenue

amounts, with production capacity. Production capacity is an amount that is not easily manipulated. Sales volume in excess of production capacity may indicate the recording of fictitious revenue.

- *Trend Analysis.* Auditors may analyze trends in the components of revenue accounts or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns. For example, a trend analysis of revenue accounts by month and customer returns by month during and shortly after the reporting period may indicate that revenue is being recognized, even though side agreements have been entered into granting customers the right to return products.

- *Ratio Analysis.* Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement amount to another. The ratio may be compared to the same ratio for a prior period (or several prior periods) to identify unusual or significant variations. For example, it may be possible to compare cost amounts, such as materials cost, to revenue amounts to detect improper revenue recognition. A recorded amount of materials cost of sales (units or dollars) that is significantly lower than the amount needed to produce the recorded units or dollars of revenue might indicate overreporting of revenue. Ratios that use information management generally is unable to manipulate, such as cash flows, may be most effective in revealing indications of fraudulent financial reporting.

- *Budgetary Comparison.* Comparison of actual amounts with budgets may also indicate unusual variations. For example, revenue might significantly exceed budget because of improper revenue recognition.

As indicated in AU-C 240.34, the analytical procedures related to revenue should be updated in the final review stage of the audit.

Documentation. Documentation of preliminary analytical procedures can be limited, but it needs to be sufficient to provide support for the auditor's risk assessment. The results of the preliminary analytical review ordinarily are documented using a narrative memorandum, comparative carryforward schedule, or other form of workpaper. Documentation may also include the effect on the audit plan or indicate that the results have been considered when identifying fraud risks.

Observation and Inspection

According to AU-C 315.06, risk assessment procedures should include observation and inspection. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the entity and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, in order to gain an understanding of the client's financing arrangements and underlying covenants, the auditor might decide to review the client's loan agreements and other related documents. That procedure, coupled with a review of the client's financial statements, might be the key procedure that helps the auditor identify risks related to potential noncompliance with loan covenants.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of management and others. For example, when evaluating the design and implementation of the entity's system of internal control, members of management might tell the auditor that they communicate the importance of ethical values to employees through a written code of conduct and by example. The auditor might wish to corroborate this response by examining the written code. In addition, the auditor may determine that a risk exists based on observation of management's current and past interactions with employees that contradict the behavior standards in the written code.

Other than the requirement to perform some observation and inspection procedures related to internal control, however, determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. Observation and inspection procedures seem likely to be effective in the following situations when obtaining an understanding of the entity:

- To understand the design of controls related to the audit.

- To verify that controls have been implemented, for example, as part of a walkthrough.

- When responses to inquiries indicate a potential risk for a significant account.
- When responses to inquiries are inconclusive, conflicting, or prove to be incorrect.
- In combination with inquiry to fully understand a matter.
- When necessary information can only or best be obtained through observation or inspection (for example, understanding the client's production processes might best be done through observation.)
- When the evidence gathered through observation and inspection can also be used for a substantive procedure.
- In recurring engagements, to determine whether changes have occurred that affect the continued relevance of the information gathered in a prior period.

Examples of how and when observation and inspection procedures might be used to identify risks are included in Exhibit 1-7.

Exhibit 1-7

Using Observation and Inspection Procedures in Risk Assessment

Audit Procedure	Example of When Used and Procedure Performed	Example of How a Potential Risk Is Identified
• Observation of entity activities and operations.	• Understanding the nature of the client's products or services. •• Observe client's products and the production process.	• Auditor observes a significant amount of returned product during the inventory observation, which indicates increased risk related to warranty obligations.
• Inspection of business plans and strategies, internal control manuals, and similar documents and records.	• Understanding the client's objectives and strategies and related business risks. •• Review the most recent business plan.	• The plan reveals a shift in marketing and revenue strategies during the year to concentrate on one industry dominated by three competitors, which indicates increased risk related to unrecognized customer discounts and rebates.
• Reading directors meeting minutes.	• Understanding the participation of those charged with governance. •• Read minutes of the board of directors during the year.	• Minutes indicate that the board "rubber-stamps" all of management's decisions and, therefore, is deemed to be ineffective, which indicates overall risk due to weaknesses in the control environment.
• Visits to the entity's premises and plant facilities.	• Understanding the nature of the client's operations. •• Tour client's key operating facilities.	• During the tour of client's production facilities, the auditor observes significant damage to uninsured machinery and equipment due to a recent storm, which indicates an increased risk of impairment.

Audit Procedure	Example of When Used and Procedure Performed	Example of How a Potential Risk Is Identified
• Walkthroughs (tracing transactions through the information system to confirm the auditor's understanding of design and determine that procedures and controls have been implemented).	• Understanding the client's financial reporting system, including its design and implementation pertaining to the billing cycle. •• Select a shipped transaction and trace it through the billing system.	• During the billing cycle walkthrough, the auditor determines that control procedures to follow-up on unbilled transactions have not been implemented, which indicates an increased risk of unrecorded revenues and receivables.
• Review of information from external sources.	• Understanding the client's industry, regulatory environment, and financial performance. •• Review one or more of the following: (a) analyst, bank, or rating agency reports on the entity or its industry, (b) trade or economic journals, or (c) regulatory or financial publications.	• A review of the trade journals indicates that one of the client's key products will soon be outdated due to the recent introduction of a technologically superior product by a competitor, which indicates an increased risk of improper inventory valuation.

* * *

Documentation. As noted earlier in this lesson, AU-C 230.09 requires that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the specific items or matters tested. AU-C 230.A14 provides examples of how this might be accomplished. Based on that guidance, it may be helpful for auditors to document the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number. (To facilitate inquiring about or requesting copies of the report or document at a later time, this course recommends referring to the report or document by the same name that the client uses to refer to it.)

- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

Discussion among the Engagement Team

AU-C 315.11 requires the key members of the audit team (including the engagement partner) to discuss the susceptibility of the entity's financial statements to material misstatements and the application of GAAP to the entity's facts and circumstances. AU-C 240.15 requires an open exchange of ideas, or *brainstorming* among audit team members about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. However, it is important that the auditor consider the susceptibility to fraud as distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

AU-C 315.A21 indicates that, in performing the engagement team discussion—

- More experienced team members (including the partner) can share their insights about the entity.
- Team members exchange information about the entity's business risks and how and where the financial statements might be susceptible to error or fraud.
- Team members gain a better understanding of the potential risk areas assigned to them and how their work may affect other audit areas.
- Team members have a basis upon which to communicate and share new information obtained throughout the audit that may affect risk assessment or audit procedures performed.

The focus of the audit team discussion ought to be on the individual members gaining a better understanding of the potential for material misstatements resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the partner and more experienced members of the audit team can share their insights based on their cumulative knowledge of the entity, its industry, and its environment. It is not always necessary or practical for the engagement team discussion to include all members in a single discussion, and not all members need to be informed of all decisions made. AU-C 315.11 states that the engagement partner and key engagement members should take part in the team discussion. In addition, the engagement partner should determine what matters are to be communicated to team members who are not involved in the team discussion.

Matters to Be Discussed. The engagement team discussion is aimed at the susceptibility of the financial statements to material misstatement (including the application of GAAP), that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement. Thus, the discussion ought to open the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, also need to be communicated to the team members.

The following matters are specifically required to be discussed during the engagement team discussion:

- The susceptibility of the entity's financial statements to material misstatement.
- The application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- The susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.
- Fraud-related matters.

In addition, focusing on the areas of vulnerability, the engagement team discussion might include the following topics:

a. Critical issues and areas of significant audit risk.

b. Areas susceptible to management override of controls.

c. Unusual accounting practices used by the client.

d. Implementation of new accounting standards.

e. Important control systems.

f. Significant IT applications and how the use of IT may affect the audit.

g. Areas susceptible to cyber attacks or intrusion that may affect the audit.

h. Materiality levels and how materiality will be used to determine the extent of testing.

i. The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

It is also a best practice for this discussion to address how the business risks facing the client could result in a material misstatement of the financial statements, focusing especially on changes from the prior year and new developments. For example, assume the client is in the business of providing advertising and related services to real estate brokers. During preliminary planning discussions with the client, the in-charge auditor learns that because the local real estate market has been very depressed during the year, many of the client's customers are experiencing severe financial difficulties. During the discussion, the audit team can focus on how that knowledge of the client's business risk would affect audit procedures by identifying the accounts that would be affected and the nature of procedures that could be performed to address the risks. Considering business risks enhances the auditor's ability to identify risks of material misstatement. However, the auditor need not identify or assess all business risks facing the client. Although most business risks will eventually have financial consequences that affect the financial statements, not all business risks give rise to risks of material misstatement.

Examples of other factors the engagement team might discuss that affect the likelihood of material misstatements caused by error include the following:

- Past experience with the client (including areas with audit difficulty and misstatements encountered).
- Changes in the client's organization (for example, changes in personnel or accounting systems).
- The nature and complexity of transactions.
- Known accounting and auditing issues.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the client's personnel and assignment of responsibilities. For some smaller entities, the engagement team might consider issues regarding the background and competence of individuals in key processing and financial decision-making roles especially if concerns had been noted in previous audits.

Related Parties. AU-C 550.13 specifically requires auditors, as part of the engagement team discussion, to consider how related party relationships and transactions could affect the susceptibility of the financial statements to material misstatement. AU-C 550.A7–.A8 indicates that the team discussion might include the following related party matters:

- Nature and extent of the entity's relationships and transactions with related parties.
- Importance of maintaining professional skepticism regarding related parties throughout the audit.
- Circumstances or conditions that may indicate the existence of unidentified related party relationships or transactions.
- Types of records or documents that might indicate the existence of related party relationships or transactions.
- Importance that management and those charged with governance attach to the identification of, accounting for, and disclosure of related party relationships and transactions and the related risk of management override.
- How related parties might be involved in fraud.

The discussion may also be a good time to remind the engagement team that if related parties or significant related party transactions are identified by the auditor that were not previously identified and disclosed by management,

the engagement team is required by AU-C 550.23 to promptly communicate such information to other team members. Also, AU-C 550.23 requires that the auditor inquire of management as to why applicable controls over related party relationships and transactions failed to identify and disclose such information.

Fraud-related Matters. AU-C 240.15 indicates that the discussion should also include the following fraud-related matters:

- How and where the entity's financial statements (for example, which accounts or transaction classes) might be susceptible to material misstatement due to fraud.
- How the entity's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
- Risk of management override of controls.
- Circumstances that might be indicative of earnings management or manipulation of other financial measures.
- Practices management might use to manage earnings or other financial measures that could lead to fraudulent financial reporting.
- How the auditor might respond to the susceptibility of the financial statements to material misstatement due to fraud.
- Importance of maintaining professional skepticism regarding potential for material misstatement due to fraud.

The fraud aspect of the discussion ought to give appropriate consideration to financial statement misstatement from both fraudulent financial reporting (i.e., "cooking the books") and stealing. A key consideration when assessing fraud risk is what motivations may exist for management to intentionally misstate the financial statements or what controls may be lacking that could result in theft. By identifying the motives and opportunities for fraud, the auditor can assess the direction of the risk. For example, if the auditor identifies an unusual motivation for management to maximize earnings and show a consistent growth trend because the entity intends to offer shares to the public in the near future, the auditor may determine that the risk is overstatement of assets and earnings.

As noted above, AU-C 240.15 requires that the discussion also include the appropriate audit response to the areas identified as susceptible to material misstatement due to error or fraud. For example, the auditor might identify the accounts that would be affected and the nature of procedures that could be performed to address the risks.

The discussion should include an open exchange of ideas (that is, *brainstorming*). AU-C 240.15 indicates that participants should set aside their beliefs that management and others are honest and have integrity and maintain an attitude of professional skepticism throughout the discussion. AU-C 315 and AU-C 240 refer to a discussion; therefore, one-sided communication, such as a memo from the engagement partner, is not appropriate. (However, when the entire engagement is performed by a single auditor, the auditor might simply consider and document the susceptibility of the entity's financial statements to material misstatements.) The medium for discussion (for example, a meeting or a conference call) ought to encourage interaction and an appropriate exchange of ideas. AU-C 240.15 indicates that communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

AU-C 240.12 indicates that, in accordance with AU-C 200, throughout the audit, the auditor should exercise professional skepticism and recognize the possibility of a material misstatement due to fraud regardless of any beliefs about the honesty and integrity of management and those charged with governance gained from past experience. AU-C 200.14 defines *professional skepticism* as "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence." Thus, auditors ought to actively consider how management could perpetrate and conceal fraudulent

financial reporting. For example, auditors may use "what if" scenarios that focus on the financial statement areas vulnerable to fraud with the presumption that management or employees are inclined (either because of incentives/pressures or attitudes/rationalizations) to perpetrate fraud. According to AU-C 200.A26, the auditor's belief that management and those charged with governance are honest and have integrity does not mean that the auditor is allowed to be satisfied with less than persuasive audit evidence.

Sample Questions. Exhibit 1-8 represents a list of sample questions that might be considered during the engagement team discussion.

Exhibit 1-8

Sample Questions for Engagement Team Discussion

General questions relating to risks of material misstatement:

- What key changes are you aware of that have occurred at the client regarding their:
  - Organization or structure?
  - Related parties?
  - Products and services?
  - Customers and market?
  - General economic environment?
  - Regulatory or legal requirements?
  - Assets, liabilities, or expenses?
  - Accounting, executive, or other critical personnel?
  - Accounting systems (including IT) and controls?
  - Accounting policies or accounting estimates?
- Are there any areas in the most recent financial statements that appear unusual or unexpected based on our preliminary review?
- Based on discussions since our previous engagement, have client personnel raised any concerns or issues about the following:
  - Accounting policies and their application or accounting estimates?
  - Application of internal controls or any known deficiencies?
  - Accounting systems or documentation?
  - Business risks?
  - Other matters that may increase audit risk?
- Are there any indications of problems in the control environment?
- Are there any known internal control deficiencies that would allow material errors to occur and remain undetected?

- Are any of the client's accounting policies unusual, poorly defined in GAAP, or otherwise inappropriate considering the conditions and circumstances?
- Where did the client have issues in the prior audit in applying or interpreting GAAP? What were the issues and are they likely to be present during the current audit?
- Are there any new accounting pronouncements or other GAAP requirements that will be applied for the first time this year? If so, will any require significant accounting estimates?
- Do you have any concerns about the competency of accounting personnel or their attitudes toward accurate financial reporting?
- For each significant account balance, transaction class, or disclosure, what do you consider to be the significant risks of material misstatement? Why?
- What significant risks did we identify in the prior audit?
- What were the known and likely audit differences in our previous audit? Are we likely to encounter similar issues in the current audit?
- What audit issues did we encounter in the prior audit? Are they likely to be present during the current audit?

Questions specifically directed to the risk of fraud:

- Why does the company have an audit? What possible motives or fraud schemes does this suggest?
- Who are the financial statement users and how do they use the financial statements? Which aspects of the financial statements are most likely to influence the users?
- Are there any known pressures that would motivate management to fraudulently misstate the financial statements?
- Which accounts or transaction classes are most susceptible to manipulation?
- Are there any known internal control weaknesses that would allow fraudulent financial reporting to occur and remain undetected?
- How would *you* fraudulently misstate the financial statements at this client?
- How would *you* conceal fraudulent financial reporting at this client?
- Which individuals in the company have the opportunity to steal assets?
- Are there any known pressures that would motivate employees with opportunity to steal assets?
- Which assets of the company are susceptible to theft, either through physical access or unauthorized transactions?
- Are there any known internal control weaknesses that would allow theft of assets to occur and remain undetected?
- How would *you* steal assets from this company?
- How could financial statement accounts be materially misstated by stealing assets?
- How would *you* conceal theft of assets at this client?

- How could related parties be involved in committing fraud?
- What factors might indicate that the company has a culture or environment that would enable management or employees to rationalize committing fraud?
- Have you observed any attitudes, behaviors, or lifestyle changes that may indicate the presence of fraud?
- Who in the company is authorized or in a position to override controls? Which controls would *you* override if you were in their position?

* * *

Effect on Significant Audit Areas. After discussing the risks that could result in a material misstatement of the financial statements and determining how those risks affect specific audit areas, it is a good idea for the engagement team to then discuss each significant audit area. The team ought to focus on the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team need to avoid relying on what procedures were performed during the prior year audit when discussing what procedures to perform in the current year. In fact, it may be best to ignore the prior year workpapers when initially discussing each significant area. That way, the audit team starts with a clean slate when developing the audit approach and avoids the temptation to just rely on "what we did last year." The result is usually a more effective and efficient audit approach. However, after the team has discussed each significant area, the prior year workpapers can be reviewed to make sure there are not any issues that were overlooked.

Who Attends the Discussion? As discussed earlier in this lesson, key members of the engagement team need to participate in a single discussion, and the engagement partner determines what matters will be communicated to other team members. In addition, it may be appropriate to include specialists, such as IT specialists, assigned to the engagement team. Executive level team members generally are aware of significant accounting and auditing issues that could affect the audit, while staff members or specialists may be more familiar with the client's accounting systems and controls. Both perspectives are important in considering the susceptibility of the financial statement to material misstatements from error or fraud. This course recommends that all members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion. Also, the discussion may include component auditors, and consideration of how the matters discussed apply to components. The engagement team, however, does not include external specialists engaged by the auditor or individuals within the internal audit function who provide direct assistance to the auditor on the audit engagement.

When Does the Discussion Occur? Before holding the discussion with the engagement team, it is a good idea for the engagement partner to have preliminary planning discussions with the client. Issues to discuss with the client include the services to be provided, scheduling, and other administrative matters. In addition, the auditor can discuss the client's business environment (particularly changes from the prior year), the client's view of the business risks that the client is addressing, and other specific issues facing the client. The auditor can also obtain additional information to be used in the planning process prior to meeting with the engagement team. Specific information to obtain includes the following:

a. Interim financial information.

b. Client budgets and any related operating and strategic planning documents.

c. Minutes of board of directors meetings.

d. Copies of new debt or other significant agreements or contracts.

e. Significant internal audit reports.

Also, if an engagement summary memo was prepared for the prior year audit, it can be reviewed before the engagement team discussion to identify risk areas identified in the prior audit.

AU-C 240 and AU-C 315 make clear that the discussion among the engagement team is expected to occur during the performance of risk assessment procedures as part of audit planning, but the exact timing is not specified. It is a best practice to hold the discussion prior to performing the information-gathering procedures discussed later in this lesson in relation to understanding the entity and its environment. This can help set the proper tone of professional skepticism and inform less experienced staff members about the risks of material misstatement before performing those procedures. However, nothing prevents the firm from holding discussions both before and during the information-gathering process. These decisions are normally made by engagement partners, and auditors need to exercise professional judgment to determine what works best in the particular circumstances. In any case, engagement team members communicate and share information obtained throughout the audit about the risks of material misstatement due to error or fraud.

Other Matters That May Be Discussed. While not a requirement of AU-C 240 or AU-C 315, the auditor might also use the engagement team discussion as an opportunity to consider other planning matters related to the audit. Those items could include, but are not to limited to, the following:

a. Critical dates and other timing considerations.

b. Engagement budgets.
c.
Key client contacts for assigned areas.

d. Other engagement administrative matters.

e. Other services that will be provided.

AU-C 220.17 requires the engagement partner to take responsibility for the direction, supervision, and performance of the audit engagement, while AU-C 220.A12 further clarifies that *direction* of the engagement team involves informing team members of certain matters. The engagement partner typically informs the engagement team of matters such as the following:

- Their responsibilities, including complying with relevant ethical requirements and applying professional skepticism when planning and performing the audit.
- If more than one partner is involved with the engagement, each of their responsibilities.
- Objectives of the work to be performed.
- Nature of the entity's business.
- Risk-related issues.
- Problems that could arise.
- Detailed audit approach to performing the engagement.

The engagement team discussion also provides an opportunity for the partner to remind the audit team members of the audit documentation requirements of AU-C 230. Among the matters that might be covered are the following:

a. Inclusion of abstracts or copies of significant contracts or agreements examined to evaluate the accounting for significant transactions.

b. Identification of items tested in tests of operating effectiveness of controls.

c. Identification of documents inspected or items confirmed in substantive tests of details.

d. Documentation relating to substantive analytical procedures.

e. Documentation relating to consideration of the entity's ability to continue as a going concern.

f. Documentation of the nature and effect of aggregated misstatements and the conclusion as to whether they cause material misstatement of the financial statements.

g. Documentation of who performed and reviewed the audit work and the date the work was performed and reviewed.

Discussion of Revenue Under the New Accounting Standard. FASB ASC 606, *Revenue from Contracts with Customers* (effective for nonpublic entities for years beginning after December 15, 2018, and interim periods beginning after December 15, 2019), ushers in comprehensive changes to the revenue recognition model to recognize revenue in the financial statements and to make appropriate related disclosures. To enhance the auditor's understanding of the entity and develop an appropriate risk assessment, the AICPA Audit and Accounting Guide, *Revenue Recognition*, indicates that the engagement team discussion may include an exchange of the following:

a. Knowledge of the different revenue streams, including controls that pertain to revenue transactions, and any changes to the revenue streams as a result of FASB ASC 606 or new performance obligations.

b. Information about the business risks related to revenue transactions.

c. Ideas about how revenue may be susceptible to material misstatement due to fraud or error.

Auditors will need to exercise professional skepticism when auditing implementation of the new revenue related accounting policies. Also, the transition process could create new opportunities to perpetrate or conceal fraud. Implementation of the new revenue recognition guidance may also present opportunities for fraud in the development of new significant accounting estimates, such as estimates for variable consideration and standalone selling prices. The additional stress and workload for auditors during the implementation period may also create incentives and pressure that act as a constraint on professional skepticism. The discussion among the engagement team members should caution auditors against allowing feeling rushed and accepting audit evidence that is insufficient in the interest of saving time.

Documentation. AU-C 315.33 requires that the following items be documented regarding the discussion among the audit team:

- How and when the discussion occurred.
- Participating audit team members.
- Significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.

As explained in Lesson 3, AU-C 240 imposes similar documentation requirements related to fraud aspects of the discussion.

Other Sources of Information for Identifying Risks of Material Misstatement

In addition to the risk assessment procedures discussed previously, the auditor considers other sources of information as follows:

a. AU-C 315.07 states that the auditor should consider whether information obtained from the client acceptance or continuance process is relevant to identifying risks of material misstatement.

b. AU-C 315.08 indicates that if the engagement partner has performed other engagements for the entity, he or she should consider whether information obtained is relevant to identifying risks of material misstatement.

It may be worthwhile to consider whether any engagements performed for the entity, no matter who the engagement partner was, could provide information relevant to identifying risks of material misstatement.

In addition, the auditor may obtain information from sources outside the entity that are useful in understanding the client and identifying risks of material misstatement. Such sources might include:

- The client's external legal counsel.
- Reports of analysts, banks, or rating agencies.
- Trade and economic journals.
- Regulatory or financial publications.
- Reports of service organizations.
- Experts used by the client that are relevant to financial reporting purposes, such as valuation experts.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What is the first planning step in the audit planning process put forth in this course?

   a. Assess audit risk at the financial statement level.

   b. Establish a preliminary audit strategy.

   c. Determine performance materiality.

   d. Perform acceptance or continuance procedures.

2. Audit procedures performed in a prior-year audit can provide useful audit evidence about which of the following?

   a. The organizational structure of the entity.

   b. How risks of fraud are addressed by the entity.

   c. Identification of risks of material misstatement due to error or fraud.

   d. Unusual or unexpected relationships.

3. Which of the following inquiries would help an auditor find out information about an entity's accounting estimates?

   a. Does the entity have any new transaction types?

   b. Were there any related-party transactions during the period?

   c. Does management have any knowledge of fraud?

   d. Is the entity in compliance with laws and regulations that affect the financial statements?

4. Which of the following would be considered an unusual or unexpected relationship if found during preliminary analytical procedures?

   a. Increased revenues and increased inventories.

   b. Decreased compensation expense with increased revenues.

   c. Decreased payables with decreased inventory.

   d. A decreasing trend in debt to equity ratios.

5. Which of the following items is a required part of the engagement team discussion?

   a. Areas where the client is susceptible to management override of controls.

   b. Past experience with the client.

   c. How susceptible the client's financial statements are to material misstatement.

   d. Critical dates and other timing considerations.

6. All of the following items about the engagement team discussion must be documented **except**:

   a. The time of the engagement discussion.

   b. Who participated in the discussion.

   c. Any significant decisions reached during the discussion.

   d. Sources of information from outside the client.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What is the first planning step in the audit planning process put forth in this course? **(Page 125)**

   a. Assess audit risk at the financial statement level. [This answer is incorrect. Assessing audit risk at the overall financial statement level is the tenth step in the audit process put forward by this course.]

   b. Establish a preliminary audit strategy. [This answer is incorrect. Based on the audit process suggested by this course, establishing a preliminary audit strategy is the fourth step. It is the first step of general audit planning at the financial statement level, but there are preliminary engagement activities that the auditor must perform first.]

   c. Determine performance materiality. [This answer is incorrect. This is the twelfth step in the audit process described in this course (though it may be performed in conjunction with the sixth step—determining preliminary planning materiality—so even though it is an iterative process, there are other planning activities that need to happen before performance materiality is determined.]

   d. Perform acceptance or continuance procedures. [This answer is correct. The audit planning process put forward by this course begins with preliminary engagement activities. The first of those activities is to perform procedures regarding acceptance or continuance of the client relationship and the specific audit engagement. Such procedures would be followed by evaluating compliance with ethical requirements, including independence, and establishing an understanding with the client, which is communicated in an engagement letter.]

2. Audit procedures performed in a prior-year audit can provide useful audit evidence about which of the following? **(Page 128)**

   a. The organizational structure of the entity. [This answer is correct. Audit procedures performed in previous audits ordinarily provide useful audit evidence about (1) the entity's organizational structure, business, controls, and operations; (2) past misstatements and whether they were corrected on a timely basis; and (3) significant changes from the prior period.]

   b. How risks of fraud are addressed by the entity. [This answer is incorrect. AU-C 240.17–.24 explains that auditors should perform certain procedures during the current audit to obtain information that is used to identify fraud risks. One such procedure is to make inquiries of management and others in the company about the risks of fraud and how they are addressed.]

   c. Identification of risks of material misstatement due to error or fraud. [This answer is incorrect. AU-C 315.06 specifically requires the auditor to make inquiries of management, internal audit, and others within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud. These inquiries should be made as part of the current-year audit engagement.]

   d. Unusual or unexpected relationships. [This answer is incorrect. AU-C 315.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information. AU-C 315.A15–.A16 explains that any unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement. However, such analytical procedures need to be performed in the current year, not the prior year.]

3. Which of the following inquiries would help an auditor find out information about an entity's accounting estimates? **(137)**

   a. Does the entity have any new transaction types? [This answer is correct. AU-C 540.08 indicates that, when obtaining an understanding of how management identifies transactions, events, and conditions requiring accounting estimates, the auditor should make inquiries of management over whether any changes in circumstances have occurred that may give rise to new accounting estimates or the need to revise existing estimates. AU-C 540.A18 indicates that inquiries of management about such changes may include matters such as whether (1) the entity has entered into new types of transactions that may give rise to accounting estimates, (2) transaction terms that affect accounting estimates have changed, and (3) accounting policies relating to accounting estimates have changed as a result of changes to GAAP.]

   b. Were there any related-party transactions during the period? [This answer is incorrect. AU-C 550.14 requires the auditor to inquire of management about the following: (1) identity of related parties, including changes from the prior period; (2) nature of related party relationships; and (3) whether there were any transactions with those related parties during the period and, if so, the transaction types and purposes. However, these inquiries are specific to related parties, not accounting estimates.]

   c. Does management have any knowledge of fraud? [This answer is incorrect. The inquiries of management made in audit planning, according to AU-C 240.17–.18, should include specific areas of inquiry including (1) whether they have knowledge of any actual, suspected, or alleged fraud; (2) management's process for identifying, responding to, and monitoring the risks of fraud in the entity; and (3) the nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments. However, these inquiries are specifically required in relation to fraud; they are not related to accounting estimates.]

   d. Is the entity in compliance with laws and regulations that affect the financial statements? [This answer is incorrect. AU-C 250.14 requires the auditor to inquire of management and those charged with governance about whether the entity is in compliance with laws and regulations that may have a material effect on the financial statements and to inspect relevant correspondence with licensing and regulatory authorities. However, these inquiries are related to compliance with laws and regulations, which is a separate consideration from accounting estimates and requires different inquiries.]

4. Which of the following would be considered an unusual or unexpected relationship if found during preliminary analytical procedures? **(Page 140)**

   a. Increased revenues and increased inventories. [This answer is incorrect. An unusual financial statement relationship would be increased revenues with *decreased or significantly unchanged* inventories.]

   b. Decreased compensation expense with increased revenues. [This answer is correct. Decreased or significantly unchanged compensation expense with increased revenues is an unusual financial statement relationship. Potential associated risks include payroll accrual recognition issues and improper cost allocation issues.]

   c. Decreased payables with decreased inventory. [This answer is incorrect. An unusual or unexpected financial statement relationship would be *increased* payables with *decreased or significantly unchanged* inventory.]

   d. A decreasing trend in debt to equity ratios. [This answer is incorrect. An unusual fluctuation or trend in account balance or ratios would be an *increasing* trend in debt to equity ratios, which could indicate loan covenant risks or going concern considerations.]

5. Which of the following items is a required part of the engagement team discussion? **(Page 145)**

   a. Areas where the client is susceptible to management override of controls. [This answer is incorrect. While this is an area of vulnerability that the engagement team *may* want to discuss related to areas of vulnerability, it is not one of the four discussion topics *required* for the engagement team to be compliance with GAAP.]

   b. Past experience with the client. [This answer is incorrect. Past experience with the client (including areas with audit difficulty and misstatements encountered) is something that the engagement team *might* discuss as it affects the likelihood of material misstatement caused by error, but it is not one of the required topics.]

   c. How susceptible the client's financial statements are to material misstatement. [This answer is correct. The following matters are specifically required by GAAP to be discussed during the engagement team discussion: (1) the susceptibility of the entity's financial statements to material misstatement, (2) the application of GAAP to the entity's facts and circumstances in light of its accounting policies, (3) the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions, and (4) fraud-related matters.]

   d. Critical dates and other timing considerations. [This answer is incorrect. While not a requirement of AU-C 240 or AU-C 315, the auditor might also use the engagement team discussion as an opportunity to consider other planning matters related to the audit, such as critical dates and other timing considerations, engagement budgets, and key client contacts for assigned areas.]

6. All of the following items about the engagement team discussion must be documented **except**: **(152)**

   a. The time of the engagement discussion. [This answer is incorrect. Per AU-C 315.33, how and when the discussion occurred must be documented.]

   b. Who participated in the discussion. [This answer is incorrect. As described in AU-C 315.33, the documentation of the engagement team discussion must include the participating audit team members.]

   c. Any significant decisions reached during the discussion. [This answer is incorrect. AU-C 315.33 requires that specific items be documented regarding the discussion among the audit team. One such item is significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.]

   d. Sources of information from outside the client. [This answer is correct. When identifying risks of material misstatement, the auditor may obtain information from sources outside the entity. One example would be the client's external legal counsel. However, documenting such sources is *not* one of the three items AU-C 315.33 requires be documented in relation to the engagement team discussion.]

OBTAINING AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT

The auditor, according to AU-C 315.05, should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. AU-C 315.03 explains that the objective of the auditor is to make this assessment through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks. Exhibit 1-1 identifies the requirements relevant to obtaining an understanding of the entity and its environment. The auditor's focus in obtaining the understanding is on attaining a knowledge level sufficient to identify the risks of material misstatement of the financial statements and to design the nature, timing and extent of further audit procedures. The understanding is a purpose-driven audit focus and not a general knowledge level that might be appropriate for some other purpose such as managing the entity.

Obtaining a solid in-depth understanding of the client's business and how it operates is fundamental to both audit efficiency and effectiveness. Understanding the business is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. Understanding the client's business includes not only understanding the risks the client faces in doing business, but ideally, understanding what management's response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains. The auditor's process in obtaining this understanding is focused on those matters that could cause material misstatements in the financial statements, including potential going-concern problems, fraud risk factors, undisclosed related-party transactions, violations of laws and regulations, or uncertainties.

The auditor's understanding of the entity also assists in:

- Establishing planning materiality and evaluating whether such judgments remain appropriate throughout the audit.

- Evaluating whether certain observed conditions, such as unusual or unexpected relationships from preliminary analytical procedures, do not make business sense and indicate possible risk considerations.

- Considering fraud risk factors, for example, the existence of significant or complex related-party transactions. Knowledge of the entity's competitors, customers, and suppliers might help the auditor consider possible collaborators in certain types of frauds, such as kickback schemes. Knowledge of key personnel might help the auditor identify employees who could provide relevant information in response to fraud risk inquiries.

- Evaluating the appropriateness and sufficiency of audit evidence.

The audit personnel working on the engagement need to sufficiently understand the client's business and industry to effectively analyze the risks and plan and perform an efficient and effective audit in response to those risks. The level of understanding that is attainable by individual members of the audit team will vary with the experience, training, and assigned engagement duties of the personnel, but the partner and manager need to spend sufficient time in audit team meetings or on-the-job supervision to convey to the assigned staff the insight needed for effective performance of the audit.

The process of understanding the client's business and industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. Also, there are always important new developments with the client and within the industry. For this reason, each member of the audit team should continually try to improve client and industry knowledge by such measures as reading industry publications, taking self-study courses, and above all, talking to client personnel, including operating personnel outside the accounting department.

In a continuing engagement, the auditor updates knowledge of the entity and its environment by focusing on identifying changes from the prior year in internal or external conditions that might be of audit significance and affect the client's business risk or the auditor's assessment of audit risk.

Components of the Understanding

AU-C 315.12 indicates that the auditor's understanding of the entity and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors.

b. Nature of the entity.

c. Objectives, strategies, and related business risks.

d. Measurement and review of the entity's financial performance.

e. Selection and application of accounting policies.

In addition, consideration of fraud risk factors is an important objective of performing risk assessment procedures. Although considering the presence of fraud risk factors occurs simultaneously with obtaining information about the entity and its environment, it merits separate and focused attention.

Documentation. In addition to the documentation of the discussion among the engagement team explained earlier in this lesson, AU-C 315.33 indicates that the auditor should include the following in the audit documentation:

- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment.
- The sources of information from which the understanding was obtained.
- The risk assessment procedures performed.

Purpose of This Discussion. The following paragraphs provide a detailed discussion of each of the aspects of the entity and its environment that the auditor is required to understand, procedures the auditor may perform to gain that understanding, and the types of risks the auditor may identify throughout that process.

Industry, Regulatory, and Other External Factors

AU-C 315.12 indicates that the auditor should obtain an understanding of industry, regulatory, and other external factors relevant to the audit. The objective of the auditor's understanding is to evaluate whether the entity is subject to specific risks of material misstatement arising from the nature of the industry, the degree of regulation, or other external forces, such as political, economic, social, technological, or competitive forces.

AU-C 315.A25–.A29 indicate that the auditor might consider factors such as the following when obtaining an understanding of industry, regulatory, or other external factors:

a. Industry conditions, including market and competition, cyclical or seasonal activity, product technology, and availability and cost of materials and supplies.

b. Regulatory environment, including relevant legislation and regulation, environmental requirements, specific regulatory requirements, direct supervisory activities, and taxation.

c. Government policies, including monetary, fiscal, financial incentives, and tariffs or trade restrictions.

d. Other external factors, including the general level of economic activity, interest rates, availability of credit, and inflation.

The Economic Environment. Financial and economic conditions may affect the entity's operations, risks, and financial reporting. That in turn may affect the auditor's responsibilities in providing auditing services. The AICPA issued an Audit Risk Alert, *General Accounting and Auditing Developments—2017/18* (AICPA Risk Alert), to help identify and respond to accounting and auditing issues related to economic developments. That AICPA Risk Alert replaces the 2016/17 alert of the same name.

The AICPA Risk Alert emphasizes the importance of understanding economic conditions facing the industry and the entity. The Alert notes that in a changing economic environment, auditors need to evaluate how changes that have occurred since the previous audit affect their reliance on information obtained from prior experience with the client. For example, changed conditions may require the auditor to reconsider his or her understanding about how the economic environment affects the entity, reassess risks, and modify planned audit procedures as the audit progresses, including risk assessment procedures.

The AICPA Risk Alert also addresses the following topics that may assist auditors when addressing risks and considering the impact of the economic climate on their audit clients:

- Economic, legislative, and regulatory developments.
- Accounting, auditing, and attestation issues and developments, including the enhancing audit quality initiative.
- Recent accounting, audit and attest, independence, and ethics developments.
- The status of outstanding accounting, auditing, and attest projects.
- Various resources auditors may find useful.

The Regulatory Environment. AU-C 250.12 states that when obtaining an understanding of the entity and its environment, the auditor should obtain a general understanding of the laws and regulations to which an entity is subject, the industry or sector in which the entity operates, and how the entity complies with laws and regulations. The auditor may consider knowledge of any history of noncompliance. Consideration of laws and regulations is discussed further in Lesson 3.

Possible Risk Assessment Procedures and Factors to Consider. In most situations, it seems likely that auditors will initially gather information and identify risks related to industry, regulatory, and other external factors through inquiry procedures. Many of the matters to be addressed are best approached through inquiry of appropriate client management and other employees. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

As discussed earlier in this lesson, the auditor might supplement inquiry procedures with inspection or other risk assessment procedures. For example, when obtaining an understanding of the industry, the auditor might read AICPA accounting and auditing guides, financial statements of other companies in the industry, textbooks or trade journals, or might subscribe to services that provide an in-depth analysis of the client's industry. The auditor might also read articles of incorporation, minutes of meetings of shareholders and directors, and important contract agreements; review several prior years' financial statements, income tax returns, and revenue agent's reports; or tour the client's facilities. Regarding the regulatory environment, the auditor should read correspondence from taxing or other regulatory authorities, and may also review applicable regulations that were recently enacted or proposed legislation that may affect the industry. The use of other risk assessment procedures, in addition to inquiry, may be influenced by matters from in the "Observation and Inspection" discussion earlier in this lesson.

Nature of the Entity

AU-C 315.12 indicates that the auditor should obtain an understanding of the nature of the entity relevant to the audit. The nature of the entity includes its operations, its ownership and governance, the types of its existing and future investments, and its structure and financing. Among other things, the understanding of the nature of the entity helps the auditor to understand the classes of transactions, account balances, and disclosures that would be expected in the financial statements. The auditor also learns about the characteristics of the entity's structure and associated risks. For example, an entity may have a complex structure with subsidiaries, other components, or multiple locations. Complex structures often give rise to risks of material misstatement, such as whether the entity has applied appropriate accounting for goodwill, joint ventures, equity investments, and consolidations. In addition, entities with complex structures often have special audit implications such as the requirements for audits of group financial statements. Furthermore, by understanding the nature of entity, the auditor learns of the ownership and relationships between the owner and other related parties. As noted in AU-C 550, *Related Parties*,

the nature of related parties and transactions may, in some circumstances, give rise to higher risks of material misstatements.

Matters that the auditor might consider about the entity's operations and its structure, ownership, and governance include the following:

a. Revenue sources.

b. Key customers.

c. Involvement in e-commerce.

d. Products or services and markets.

e. Conduct of operations, such as methods of production and delivery of products or services.

f. Important suppliers.

g. Major assets and liabilities.

h. Major expenses.

i. Employment and human resource matters, including compensation methods and employee benefits.

j. Research and development activities and expenditures.

k. Related parties and transactions with them.

l. Location of facilities.

m. Types of investments.

n. Financing activities.

Because revenue is generally a significant class of transactions, the auditor normally places emphasis on understanding matters related to revenue recognition. As a result, in addition to understanding the types of products and services offered, the auditor normally will need to understand matters such as the client's pricing and credit policies, delivery terms, discounts offered, rights of return, seasonality of revenues, marketing and revenue promotion programs, and compensation arrangements that depend on the entity's recorded revenue. Matters that the auditor might consider about investments and financing depend on the relative importance of those activities.

Risk Assessment Procedures and Factors to Consider. Similar to the understanding of industry, regulatory and other external factors, the auditor often initially makes inquiries of appropriate client personnel about matters pertaining to the nature of the entity. To make effective risk-based inquiries, it is critical that the auditor identify the right person within the entity that possesses not only the requisite knowledge about the matter queried, but also about the nature of risks, how the entity has addressed them, and what the remaining risk is to the entity. For example, in many small-to-midsized entities, the auditor may be able to confine all inquiries about the nature of the business to the owner/manager or chief executive officer. As the size, complexity, and management structure expands within an entity, the auditor might need to direct questions regarding revenues, marketing, and customers to the chief financial officer or director of sales; for production related matters, to the director of operations; and for investments and financing, to the treasurer.

The auditor's inquiries may be supplemented by additional inquiries (and other risk assessment procedures as discussed below) as deemed necessary to fully understand the entity, its operations, structure, ownership, governance, related parties, investments, and financing so that related risks can be identified. The understanding also provides the auditor with an expectation of what classes of transactions, account balances, and disclosures will be present in the financial statements. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

When obtaining an understanding of the nature of the entity, the auditor is likely to supplement or corroborate inquiries with other risk assessment procedures. The factors noted in the "Observation and Inspection" discussion earlier in this lesson might influence when an auditor uses inspection or observation, but frequently the performance of procedures other than inquiry will be considered necessary to obtain information that normally would not be practical to obtain through inquiry. Exhibit 1-9 illustrates the use of risk assessment procedures other than inquiry that the auditor might perform when obtaining an understanding of the nature of the entity.

Exhibit 1-9

Illustrative Risk Assessment Procedures Other Than Inquiry—Nature of the Entity

Area	Procedure	Subject Matter
Structure, Ownership, Governance, and Related Parties	• Inspection and Review	• Articles of Incorporation. • Stockholder listings. • Organization charts. • Board and audit committee minutes.
Nature of the Entity—Business Operations—Revenue Sources	• Inspection and Review	• Management reports and analyses on revenues trends. • Internal revenue reports by customer. • Bad debt summaries. • Company websites to identify e-commerce activities.
Nature of the Entity—Business Operations—Products or Services and Markets	• Inspection and Review • Observation	• Industry reports that describe competition and products. • Company website describing products and marketing. • Internal reports analyzing vendor purchases. • Tours of the client's production facilities.
Nature of the Entity—Business Operations—Other	• Inspection and Review • Observation	• Interim financial statements to identify major assets, liabilities, and categories of expense. • Summary or detail plan documents for employee benefit plans. • Employee handbook to identify benefits. • Tour of company facilities noting assets and their condition.
Nature of the Entity—Investments	• Inspection and Review	• Interim financial statements to identify investment activity. • Financial statements for investments in other entities.
Nature of the Entity—Financing	• Inspection and Review	• Interim financial statements to identify extent of financing activity and leverage. • Loan agreements. • Significant lease documents.

* * *

Objectives, Strategies, and Related Business Risks

AU-C 315.12 indicates that the auditor should obtain an understanding of the entity's objectives, strategies, and related business risks. The basic concept here is that most business risks eventually have financial consequences and, thus, an effect on the financial statements. Examples of the consequences of business risks for financial reporting are as follows:

a. A diminishing customer base due to industry consolidation might increase the risk associated with the valuation of receivables.

b. Significant transactions with related parties might increase the risks of material misstatement of a range of significant account balances and relevant assertions.

c. A decline in the industry in which the entity operates might affect its ability to continue as a going concern for a reasonable period of time.

Not all business risks create risks of material misstatement, so the auditor needs to focus on business risks that have financial reporting implications in the entity's particular circumstances.

The auditor obtains an understanding of management's objectives and strategies to identify the related business risks. Management and directors determine the entity's objectives which are the overall plans for the entity. Management's strategies are the operational approaches adopted to achieve the objectives. The related business risks are the significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives or implement its strategies. When obtaining an understanding of the entity's objectives and strategies, it is often helpful to consider whether strategies align with objectives and if strategies have been implemented. By doing so, the auditor may become aware of heightened or additional business risks and potential risks of material misstatement.

When identifying relevant business risks, the auditor needs to be alert for changes in the client's business strategies, such as a new service line. Also, it is important to consider changes in external or internal conditions for which the client does not adopt an appropriate strategy, such as a shift in the client's market for its products. Furthermore, operational complexities may result in business risk. For example, a construction client may plan to enter into a major new construction project that introduces business risk in the areas of pricing, costing, design, and performance.

Risk Assessment Procedures and Factors to Consider. When obtaining an understanding of management's objectives and strategies to identify the related business risks, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the client. Smaller entities generally do not have formal plans or processes that are documented, which forces the auditor to rely primarily on inquiries. In contrast, some larger or more sophisticated entities may have written strategic plans that provide a road map for the objectives, strategies, and associated business risks that have been selected and identified by the management team.

When making inquiries, the auditor will generally restrict questioning to upper management of the entity given the subject matter and the level of knowledge that is needed to sufficiently address it. These inquiries would prompt management to describe the entity's future trends, expectations, objectives, and strategies in areas such as the following:

- Industry or regulatory developments.
- Products and services.
- Marketing and sales.
- Research and development.
- Technology.

- Business expansion or restructuring.
- Financing requirements.
- Human resources.

Identifying Business Risks. Exhibit 1-10 provides examples of the types of business risks that might be identified based on the entity's objectives and strategies, and the potential consequences for financial reporting.

Exhibit 1-10

Illustrative Entity Objectives, Related Potential Business Risks, and Financial Reporting Consequences

Entity Objectives	Related Business Risks	Consequences for Financial Reporting
Expansion of the entity's retail outlets into a new geographic area.	Inability to generate requisite cash flows due to revenue not meeting forecasts.	Defaults on loan covenants resulting in debt classification issues.
Introduction of a new product that is similar to a popular product of a competitor.	Increased legal exposure due to patent infringement.	Legal contingencies resulting in possible accrual and/or disclosure.
Increased emphasis on sales with contract terms that differ from existing contracts with customers and that require different revenue recognition policies and practices.	Improper revenue recognition.	Revenue misstatements.
Installation of a new ERP IT system.	Inability to process transactions due to implementation delays or failures.	Completeness of financial transactions or other integrity issues.
Reduction of operating expenses by 20% through employee layoffs affecting 300 individuals.	Increased exposure to EEOC complaints and other employee-based litigation.	Legal contingencies resulting in possible accrual and/or disclosure.

* * *

Measurement and Review of the Entity's Financial Performance

AU-C 315.12 indicates that the auditor should obtain an understanding of the measurement and review of the entity's financial performance made by management and external parties. Information used by management for measurement and review might include the following:

a. Key performance indicators (KPI), both financial and nonfinancial.

b. Trends.

c. Key ratios and other operating and financial statistics.

d. Forecasts, budgets, and variance analyses.

e. Period-on-period financial performance.

f. Employee performance measures.

g. Subsidiary, division, department, or other performance reports.

h. Comparisons to competitors' performance (i.e., benchmarking).

Information prepared by external parties might include analyst reports and credit rating agency reports.

Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement in several ways, including the following:

a. The pressure to meet performance targets could motivate management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment.

b. Use of performance measures might highlight unexpected results or trends such as unusually rapid growth, which upon investigation result in detection of misstatements.

c. The auditor might be able to use key performance indicators or other measures used by management when performing analytical procedures. However, the auditor needs to consider whether the information used by management is reliable and provides the degree of precision that is needed for the analytical procedures.

As noted in item a, management may be motivated to manipulate account balances that affect key performance indicators. For example, in a situation where management has guaranteed the debt of the company, if the ratio of a key expense to revenue is an important metric, management might have an incentive to improperly capitalize a portion of that expense. A small entity might not have a formal process to measure and review financial performance, but management will still likely be aware of key performance indicators that it uses and that can be helpful to the auditor.

Risk Assessment Procedures and Factors to Consider. The procedures used by the auditor for understanding the measurement and review of the entity's financial performance will often be driven by the size and sophistication of the entity. For example, a sophisticated entity may have developed a "dashboard" reporting system that incorporates carefully selected key performance indicators that management has deemed to be the primary metrics in achieving its goals and objectives. In that case, the auditor could inspect and review these measures along with any accompanying analyses in order to identify risks that may be indicative of material misstatement.

In a smaller entity, management may have identified key financial performance indicators that it uses when managing the business, but it prepares no formal reporting or analyses. Instead, as management reviews financial or other operating reports, a determination is made whether the business has achieved the targets that management has established for these indicators. For these situations, the auditor would likely use inquiry to determine what indicators management believes are important in managing and measuring the entity's results and inspect the reports that are used to monitor performance.

For all situations, the auditor considers inquiring whether there is any external measurement of the entity's financial performance such as by credit agencies, analysts, or the entity's creditors. If so, the auditor may review available reports to identify potential risks.

Business and Other Risks. Exhibit 1-11 provides examples of the measurement and review of the entity's financial performance and how it could affect the audit and the auditor's assessment of the risks of material misstatement.

Exhibit 1-11

Examples of How Performance Measures Might Affect the Audit

Measurement and Review Indicator	Potential Impact
A key performance indicator for a service line is average billing rate. The compensation and bonus structure for the service line leader is dependent upon whether the targeted average billing rate is met or exceeded.	Potential motivation for the service line leader to establish improper billing accrual rates or devise other improprieties in time reporting.
A key percentage used by the entity is gross profit by product line. For one of the entity's significant products, the gross profit ratio has varied monthly without any substantial changes in revenue mix.	Potential misstatements due to errors in billing cutoff or cost of revenue recognition.
The entity prepares monthly period-on-period comparisons and analysis for key P&L components.	The auditor might use the results of the entity's analysis to identify risks of potential material misstatement if the information is deemed reliable and provides the necessary precision to detect material misstatements.

* * *

Selection and Application of Accounting Policies

AU-C 315.12 states that the auditor should obtain an understanding of management's selection and application of accounting policies and evaluate whether the policies are appropriate for the entity's business and consistent with policies used in the relevant industry. Further, AU-C 540.08 indicates that the auditor should obtain an understanding of the following regarding accounting estimates:

- Requirements of GAAP relevant to the accounting estimates, including those related to disclosures.
- How management identifies transactions, events, and conditions that may give rise to accounting estimates.
- How management makes accounting estimates and the data on which estimates are based, including—
  - Methods used, including models if applicable.
  - Relevant controls.
  - Whether a specialist was used.
  - Assumptions underlying accounting estimates.
  - Any changes in methods or assumptions made, or that ought to have been made, from the prior period and reasons for those changes.
  - Whether and how management has assessed the effect of estimation uncertainty.

Gaining an understanding of the selection and application of accounting policies and accounting estimates is important for considering the risks of material misstatement at both the financial statement and relevant assertion levels, including both misstatements due to fraud and those due to error. The auditor's assessment of the appropriateness of the accounting policies that management has selected and applied is an important element in determining what can go wrong in the preparation of financial statements and, hence, in assessing risks of material misstatement.

FASB ASC 235, *Notes to Financial Statements*, explains that the accounting policies of an entity are the specific accounting principles and the methods of applying those principles that are judged by management of the entity as the most appropriate in the circumstance to present fairly financial position, operating results, and cash flows in conformity with GAAP. Thus, accounting policies include the accounting principles as prescribed by relevant accounting pronouncements as well as the methods adopted to apply those principles in the circumstances. When an accounting pronouncement permits an alternative in the way an accounting principle is applied or does not dictate a specific method of application, management has to adopt a method that is most appropriate in the circumstances. For example, FASB ASC 450, *Contingencies*, and FASB ASC 310, *Receivables*, provide some guidance on estimating the loss for uncollectible receivables, but do not mandate a particular method of estimation. Management needs to develop an accounting policy to determine when it is probable the contractual amount of a receivable will not be collected and what the amount of the loss will be. The auditor needs to obtain an understanding of the accounting policy and its application and evaluate the appropriateness in the circumstances.

The auditor's understanding of management's selection and application of accounting policies includes the following:

a. Relevant accounting standards and industry specific practices.

b. The methods the entity uses to account for significant and unusual transactions.

c. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

d. Changes in the entity's policies, including the reasons for the change and whether the change is appropriate and consistent with GAAP.

e. Financial reporting standards and regulations that are new to the entity and management's plans to adopt such requirements, including new accounting standards.

f. The process used by management in formulating particularly sensitive accounting estimates.

g. The methods used to identify matters for disclosure and how the entity achieves clarity in disclosure.

The auditor uses the understanding of these aspects of management's selection and application of accounting policies to identify audit areas of higher risk and to identify what could go wrong at the relevant assertion level. For example, if the entity has to apply a relatively complex accounting standard to a new type of significant transaction there ordinarily is a higher risk of material misstatement for the account balance affected. For items of disclosure, many auditors of smaller entities assist management in preparing the financial statements. In those cases, identification and clarity of disclosures are often heavily influenced by the auditor. Therefore, the potential for risk may be mitigated with respect to disclosure.

The auditor uses the understanding of management's selection and application of accounting policies along with the identification of fraud risk factors to evaluate whether an overall response is necessary. AU-C 240.29 indicates that in determining overall responses to fraud risk, the auditor should evaluate whether the selection and application of accounting policies, particularly policies related to subjective measurements and complex transactions, may be indicative of—

- Fraudulent financial reporting to manage earnings.
- Bias that may create a material misstatement.

AU-C 240.A41 observes that management bias in the selection and application of accounting principles may individually or collectively involve matters such as the following:

- Contingencies.
- Fair value measurements.

- Revenue recognition.
- Accounting estimates.
- Related party transactions.
- Transactions without a clear business purpose.

In establishing the overall audit strategy, the auditor focuses on whether the accounting principles selected and policies adopted are being applied in an inappropriate manner. If the auditor identifies a risk in this area, it is often addressed by an overall response, such as the assignment of more experienced personnel and a higher level of supervision, as well as by the selection of specific further audit procedures.

Risk Assessment Procedures. The nature and extent of the risk assessment procedures to obtain an understanding of the selection and application of accounting policies normally depend on factors such as:

- The auditor's knowledge and experience with the client's business and industry.
- The auditor's knowledge and past experience with the client.
- The degree of financial reporting sophistication of the client.
- The extent of new accounting standards that are recently effective for the client.
- The auditor's participation in assisting the client with the selection of accounting policies and the preparation of the financial statements.

For many small business clients, the auditor is instrumental in assisting with the selection of accounting principles and choosing the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process since the auditor already possesses much of the requisite knowledge. The auditor in those cases can generally confine inquiries of the client to matters such as the manner and consistency of application.

For other situations where the auditor is not involved in the selection of accounting policies or has limited experience with the client, the auditor may inquire about the matters discussed above in relation to management's selection and application of accounting policies (e.g., relevant accounting standards). Also, the auditor may supplement inquiries with a review of interim or prior year financial statements and supporting disclosures (for initial audits) coupled with a thorough review and understanding of relevant accounting standards that are either new or specifically applicable to the client's industry or its transactions.

Fraud Risk Factors

Fraud risk factors are events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present.

The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the entity and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels. The auditor's primary concern in considering fraud risk factors is to identify whether a risk factor is present and needs to be considered in identifying and assessing risks of material misstatement due to fraud. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and needs to be considered in identifying and assessing the risks of material misstatement due to fraud is a matter of professional judgment.

Examples of Fraud Risk Factors. AU-C 240.A75 provides examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The risk factors are further classified into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the illustrative risk factors are further classified into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. It is important to note that these are only examples and the auditor also may consider other risk factors not specifically listed. In fact, AU-C 240.A75 states:

> Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances.

Auditor's Consideration of Fraud Risk Factors. For misappropriation of assets, the consideration of fraud risk factors is influenced by the degree to which assets susceptible to misappropriation are present. However, some consideration is given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. As discussed in Lesson 3, one of the primary fraud risks in small businesses is fraudulent cash disbursements, in which case there is always an asset subject to misappropriation. Similarly, securities in the custody of a broker may be susceptible to misappropriation through unauthorized trading. Therefore, there always ought to be some consideration of fraud risk factors related to misappropriation. In addition, when considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting occurs.

The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. The auditor, during the course of the audit, may become aware of information that indicates potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation. Examples include:

- Anticipated layoffs that are known to employees.
- Unfavorable changes in employee compensation or benefit plans.
- Failure to receive promotions or other expected rewards.
- Abusive or overbearing management coupled with unreasonable expectations.
- Known unusual changes in behavior or lifestyle.
- Employees that are known to be experiencing significant personal financial obligations.
- Behavior indicating dissatisfaction with the company, including disregard for company policies and procedures.

If the auditor becomes aware of the presence of these or similar risk factors, he or she considers them when identifying the risks of material misstatement due to fraud.

One fraud risk factor noted by the auditor in relation to fraudulent financial reporting is, "If the entity is not owner-managed, management is dominated by a single individual or small group without compensating controls." What about owner/manager dominance, then, in the small owner-managed entity? This course suggests that domination of management by a single individual does not, in and of itself, indicate a failure by management or the owner/manager to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In fact, in many small businesses, strong owner/manager involvement actually can be a control strength in that there is a great deal of oversight of employees throughout the process. The effect of owner/manager dominance is discussed further beginning in Lesson 3. Additionally, AU-C 550.20 indicates that a fraud risk factor may exist when an entity has related parties who have the ability to exert control over, or significantly influence, management or the entity.

Auditors need to focus on the choice of modifying words in the risk factors (such as *inappropriate* means, *unduly* aggressive, etc.). For example, a fraud risk factor might be, "There is an interest by management or the owner/manager in employing *inappropriate means* to minimize reported earnings for tax-motivated reasons." Many businesses have an interest in minimizing reported earnings to reduce income taxes. The primary consideration, however, is whether the owner/manager has shown an interest in minimizing income through inappropriate means. The auditor may have knowledge from prior audits of the owner/manager attempting to run personal expenses through the business in an effort to reduce income taxes. This situation would likely be considered a fraud risk factor. However, if the owner/manager is interested in minimizing taxes through legitimate means, such as sophisticated tax planning, then the auditor would not consider this to be a fraud risk factor.

If fraud risks are present, in accordance with AU-C 330, AU-C 240.28, and AU-C 240.30, the auditor considers whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transactions, or disclosures at the relevant assertion level, or both. An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following statements best describes an aspect of obtaining an understanding of an audit client and its environment?

   a. That understanding is made up of two components—the nature of the entity and external factors such as industry and regulations.

   b. The sources of information as well as the risk assessment procedures performed while obtaining the understanding should be documented.

   c. Typically, the economic environment is not a pressing concern when obtaining an understanding of the entity.

   d. Obtaining an understanding of the entity's business objectives is important to understanding the nature of the entity.

8. The Sweet Shoppe decides to open additional stores in two new geographic areas. What consequences might this business risk have on the Sweet Shoppe's financial reporting?

   a. The Sweet Shoppe's revenue may be misstated on its financial statements.

   b. The Sweet Shoppe might have issues with the integrity of its financial transactions.

   c. The Sweet Shoppe might default on loan covenants, which would result in debt classification issues.

   d. The Sweet Shoppe may face legal contingencies that could result in possible accrual and/or disclosure.

9. Existence of which of the following indicates the possibility of fraud due to financial stress and/or the employee dissatisfaction?

   a. The entity recently adopted a new employee benefit plan.

   b. Employees who are known for upholding company policies and procedures.

   c. The entity promotes employees based on a development schedule.

   d. Employee knowledge of anticipated layoffs.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Which of the following statements best describes an aspect of obtaining an understanding of an audit client and its environment? **(Page 161)**

    a. That understanding is made up of two components—the nature of the entity and external factors such as industry and regulations. [This answer is incorrect. AU-C 315.12 indicates that the auditor's understanding of the entity and its environment consists of an understanding of *five* items: (1) industry, regulatory, and other external factors; (2) nature of the entity; (3) objectives, strategies, and related business risks; (4) measurement and review of the entity's financial performance; and (5) selection and application of accounting policies.]

    b. The sources of information as well as the risk assessment procedures performed while obtaining the understanding should be documented. [This answer is correct. AU-C 315.33 indicates that the auditor should include the following in the audit documentation: (1) key elements of the understanding obtained regarding each of the aspects of the entity and its environment, (2) the sources of information from which the understanding was obtained, and (3) the risk assessment procedures performed.]

    c. Typically, the economic environment is not a pressing concern when obtaining an understanding of the entity. [This answer is incorrect. Financial and economic conditions may affect the entity's operation, risks, and financial reporting. That, in turn, may affect the auditor's responsibilities in providing auditing services. Therefore, it is important to consider the economic environment when obtaining an understanding of the entity and its environment.]

    d. Obtaining an understanding of the entity's business objectives is important to understanding the nature of the entity. [This answer is incorrect. These are two different topics. Auditors need to obtain an understanding of objectives, strategies, and related business risks. However, they also need to obtain an understanding of the nature of the entity, which includes its operations, its ownership and governance, the types of its existing and future investments, and its structure and financing.]

8. The Sweet Shoppe decides to open additional stores in two new geographic areas. What consequences might this business risk have on the Sweet Shoppe's financial reporting? **(Page 166)**

    a. The Sweet Shoppe's revenue may be misstated on its financial statements. [This answer is incorrect. Revenue misstatements are a financial reporting consequence that may occur with the business risk of improper revenue recognition. Improper revenue recognition might occur when there is an increased emphasis on sales with contract terms that differ from existing contracts with customers and that require different revenue recognition policies and practices, which is not the case in this scenario.]

    b. The Sweet Shoppe might have issues with the integrity of its financial transactions. [This answer is incorrect. If one of the entity's objectives is to install a new ERP IT system, the related business risk is the inability to process transactions due to implementation delays or failures. The consequences of such a risk affect the completeness of financial transactions or other integrity issues. However, such an IT change did not occur in this scenario.]

    c. The Sweet Shoppe might default on loan covenants, which would result in debt classification issues. [This answer is correct. The associated business risk with expansion of an entity's retail outlets into a new geographic area is the inability to generate the requisite cash flows due to sales not meeting forecasts. If that happened, the consequences for financial reporting could be defaults on loan covenants resulting in debt classification issues.]

    d. The Sweet Shoppe may face legal contingencies that could result in possible accrual and/or disclosure. [This answer is incorrect. If the Sweet Shoppe planned to introduce a new product that is similar to a

popular product sold by a competitor, the related business risk is increased legal exposure due to patent infringement. The financial reporting consequences would be legal contingencies resulting in possible accrual and/or disclosure. However, since that did not happen in this scenario, there is a better answer choice for this question.]

9. Existence of which of the following indicates the possibility of fraud due to financial stress and/or the employee dissatisfaction? **(Page 171)**

   a. The entity recently adopted a new employee benefit plan. [This answer is incorrect. Adopting a new employee benefit plan, in and of itself, does not indicate increased fraud risk. However, if there are unfavorable changes in employee compensation or benefit plans, the auditor should be alert for possible misappropriation of assets.]

   b. Employees who are known for upholding company policies and procedures. [This answer is incorrect. A risk factor that could indicate fraud due to misappropriation of assets is when employees exhibit behavior that indicates dissatisfaction with the company, including disregard for company policies and procedures. Upholding company policies and procedures seems more likely to indicate that employees are satisfied with their employment and, thus, less likely to misappropriate assets.]

   c. The entity promotes employees based on a development schedule. [This answer is incorrect. Fraud due to misappropriation of assets is more likely when employees are dissatisfied, which they would be after failure to receive promotions or other expected rewards. If the entity upholds an understood timeline for promotions, employees are less likely to be dissatisfied because it is easier for them to track their progress.]

   d. Employee knowledge of anticipated layoffs. [This answer is correct. The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. One example of such risk factors for fraud is anticipated layoffs that are known to employees. Employees may feel justified in committing theft due to upcoming unemployment.]

Lesson 2: Understanding Internal Control, Entity-level Controls, and Activity-level Controls

INTRODUCTION

This lesson takes a look at more general planning procedures that are important to a continuing audit engagement with a nonpublic company. It begins with a basic discussion of how to obtain an understanding of the audit client's internal control and provides a practical approach for doing so.

Lesson 2 then expands its look at internal control by examining the entity-level and activity-level controls audit clients will likely have and discusses how the auditor should obtain an understanding of such controls.

Entity-level controls include the control environment, risk assessment, information and communication, and monitoring, as well as the information technology (IT) environment and general IT controls. Activity-level controls include those related to the financial reporting system and other control activities which require an additional understanding.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how to obtain an understanding of the audit client's internal control.
- Recognize how to obtain an understanding of the audit client's entity-level controls.
- Identify and obtain an understanding of the audit client's activity-level controls.

OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL

AU-C 315.13–.25 establishes requirements for auditors related to consideration of internal control as part of an audit. It also provides guidance about how the entity's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit. Auditors should obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and design the nature, timing, and extent of further audit procedures. This section provides an overview of the general requirements of AU-C 315 related to obtaining an understanding of internal control. Guidance is provided on the nature and extent of the auditor's understanding, the requirement to understand controls related to significant risks and risks for which substantive procedures alone are not sufficient, and the effect of information technology on internal control. It also provides a practical step-by-step approach for obtaining an understanding of internal control, which involves focusing on key controls and principles/control objectives to effectively and efficiently evaluate the design and implementation of controls relevant to the audit. Detailed guidance on evaluating the design and implementation of entity-level controls and activity-level controls is provided later in this lesson.

Components of Internal Control

AU-C 315.15–.25 requires an understanding of five interrelated components of internal control. These five components are also defined and described in more detail in The Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Internal Control—Integrated Framework*, as discussed below. The five components are as follows:

a. Control environment.

b. Risk assessment.

c. Information and communication.

d. Monitoring.

e. Control activities.

AICPA Technical Question and Answer, *Obtaining an Understanding of Internal Control Relevant to the Audit* (Q&A 8200.18), points out that the AU-C 315 requirement to obtain an understanding of internal control relevant to the audit applies to each of the five components of internal control. In other words, each of the five components is relevant in all audits and is required to be understood, and that understanding of each component is required to be documented in every audit engagement.

AU-C 315.A57 notes that the five components of internal control provide a useful framework for auditors when considering different aspects of internal control. AU-C 315.A58 indicates that auditors may use different terminology or frameworks to describe various aspects of internal control providing that the five components of internal control listed above are addressed. As such, AU-C 315 recognizes that entities may design, implement, or maintain internal control using terms different from those five components, and AU-C 315.A52 recognizes that the five components may not be clearly distinguished in smaller, less complex entities. Those entities might not have extensive or formal descriptions of internal controls, descriptions of accounting procedures, or detailed policies. Furthermore, in owner-managed entities, the owner/manager may perform functions that cover several different components of internal control.

Throughout this discussion, this course refers to the internal control components of control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-level" or "company-level" controls. Those controls typically have a pervasive effect on the entity's system of internal control and can, therefore, potentially influence the design and operating effectiveness of other controls. The IT environment and general IT controls also have a pervasive effect and are considered at the entity level. This course refers to the financial reporting system and the control activities component of internal control as "activity-level" controls.

COSO Internal Control Framework. As noted above, different terminology or frameworks can be used to describe various aspects on internal control. While a number of internal control frameworks exist internationally, the most widely used framework in the U.S. is COSO's *Internal Control—Integrated Framework* (the COSO framework). The five components of internal control discussed in this lesson are the same five components that are defined and described in the COSO framework. (The AICPA Risk Assessment Audit Guide references the COSO framework and related publications in various discussions of the auditor's understanding of internal control.)

Although small nonpublic entities may not have formally adopted or even be familiar with the COSO framework, it is a good idea for auditors to turn to the COSO framework as a reference and guide for understanding and evaluating internal control as it relates to their clients.

COSO Framework. Since the issuance of the original COSO internal control framework in 1992, there have been dramatic changes in business and operating environments, making businesses more complex, technologically driven, and global. In May 2013, COSO issued an updated *Internal Control—Integrated Framework* (2013 Framework) to help entities design, implement, and evaluate internal control in light of current business and regulatory environments and operations. While similar to the 1992 Framework in many ways, the 2013 Framework enhances and clarifies a number of the concepts in the 1992 Framework, to make it easier to use and apply. For example, fundamental concepts in the 2013 Framework are expressed as principles. The 2013 Framework articulates 17 principles, which are associated with the five components of internal control. The principles aid in understanding the requirements for effective internal control and provide clarity when designing and implementing systems of internal control. Each principle has several underlying points of focus for evaluating the principle. Concurrently with the 2013 Framework, COSO issued several related documents that provide tools, approaches, and examples to assist entities when designing, implementing, and assessing effectiveness of a system of internal control.

The AICPA Risk Assessment Audit Guide discusses various aspects of the COSO Framework. For example, observations and suggestions are included, when relevant, that discuss the 17 principles associated with the five components of internal control. Furthermore, Appendix C of that guide explains how the concepts in AU-C 315 correspond to the COSO framework and its 17 principles to help auditors relate the framework to the auditing standards. The audit guide also reminds auditors that while GAAS does not require the use of a specific framework, the COSO internal control framework is widely used by entities in connection with their internal control systems.

Nature of the Auditor's Understanding

AU-C 315.13–.14 requires auditors to obtain an understanding of internal control relevant to the audit. As noted in a nonauthoritative AICPA Technical Question and Answer, *Ineffective Controls* (Q&A 8200.11), auditors obtain a sufficient understanding of the five components of internal control to evaluate the design of controls and determine whether they have been implemented, even if the auditor believes, prior to performing risk assessment procedures, that controls are nonexistent or ineffective. AICPA Technical Question and Answer, *Obtaining an Understanding of the Controls Relevant to the Audit* (Q&A 8200.19), also notes that the requirement to evaluate design and determine whether the controls have been implemented applies to each of the five components and is required every year. A key consideration is whether and how the entity's internal control prevents, or detects and corrects, material misstatements in relevant assertions related to transaction classes, account balances, or disclosures.

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, a control deficiency may exist that needs to be communicated to management and those charged with governance, as more fully described in AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

It is not enough to simply determine whether a control as described or documented is effective in design. Many sophisticated entities have extensive policies and procedures manuals that provide intricate descriptions of controls, their objectives, and the procedures that are supposed to be followed to achieve the objectives. The documentation of a control procedure, however, does not demonstrate that the control is actually being used. The auditor, therefore, also needs to determine if the control, as documented or described, actually exists and the entity is using it. In other words, the auditor uses risk assessment procedures to obtain audit evidence that the control has been implemented. Determining whether a control has been implemented confirms the auditor's understanding of control design and helps ensure that the risk assessment is based on accurate information. Generally, the auditor uses procedures such as observation or inspection, along with inquiries, to verify implementation. According to AU-C 315.14, the auditor should evaluate the design of controls and determine whether they have been implemented by performing procedures in addition to inquiry. In other words, inquiry alone cannot provide a sufficient understanding of internal control.

Extent of the Auditor's Understanding

The overriding criterion for the understanding of internal control is that it be *sufficient* to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor to develop a fairly thorough and robust knowledge of all five of the components of internal control. AU-C 315.26–.27 indicates that to provide a basis for designing and performing audit procedures, the auditor should identify and assess the risks of material misstatement throughout the process of obtaining an understanding of the entity and its environment, including the relevant controls that relate to the risks. The auditor is not permitted to simply default to high control risk.

In most cases, the auditor's understanding of internal control will be more comprehensive than the understanding of the other aspects of the entity and its environment discussed in Lesson 1, and obtaining it will require more time. In addition, for initial audit engagements, the effort and time to gather information on the components of internal control that is sufficient to assess risk will most likely exceed that necessary for engagements in following years. However, the auditor is not required to obtain an understanding and evaluate all of the controls at the client. The use of the auditor's professional judgment is paramount in determining which controls are relevant to the audit and, thus, require an understanding and evaluation. In general terms, the extent of the understanding, along with the nature, timing, and extent of the risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

- The auditor's prior experience with the client.
- Materiality.
- Significance of the related risk.

- Size of the entity.
- Nature of the client's business, including its organization and ownership characteristics.
- Diversity and complexity of operations.
- Nature and complexity of systems within the organization, including the use of service organizations.
- Applicable legal and regulatory requirements.
- Level of business and financial sophistication of the client.
- The facts and circumstances relevant to the applicable control component.
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements.

The results of preliminary engagement activities and the auditor's understanding of the entity and its environment other than internal control generally influence the extent of the understanding of internal control components. Most of the factors noted in the preceding paragraph are determined to a major degree when the auditor performs risk assessment procedures to understand the entity and its environment. Furthermore, that understanding often results in the identification of risks of material misstatement that further shape the direction, extent, and depth of the auditor's understanding of internal control. (However, the auditor ought to be aware that additional risks of material misstatement may be identified when obtaining an understanding of internal control and by performing further audit procedures.) Therefore, it is recommended that the auditor perform risk assessment procedures related to the understanding of the entity and its environment before obtaining an understanding of internal control.

Exhibit 2-1 provides examples of how the auditor's understanding of the entity and its environment as discussed in Lesson 1 might influence the extent (and focus) of the understanding that will be necessary for internal control.

Because the extent of understanding of internal control is a matter of professional judgment, auditors will often struggle over what controls or combinations of controls to assess. As indicated previously, the auditor needs to remember that it is not necessary to obtain an understanding of every control at the client. To do so would be cost prohibitive and simply unnecessary for most audit engagements. Rather, the auditor's focus is on those key controls that are relevant to the audit. The auditor makes an informed judgment as to the controls or combination of controls to assess. Although the extent of the auditor's understanding is a matter of professional judgment, AU-C 315.15–.25 provides certain specific requirements related to the understanding of internal control components, which are discussed later in this lesson. In addition, according to AU-C 315, the auditor should understand and evaluate the following specific matters:

- The design and implementation of controls, including relevant control activities, related to significant risks (AU-C 315.30).
- The controls over risks for which substantive procedures alone are not sufficient (i.e., risks requiring tests of controls to obtain sufficient audit evidence) (AU-C 315.31).
- The effect of IT on internal control, specifically how IT risks affect control activities (AU-C 315.22).

Exhibit 2-1

Examples of How the General Understanding of the Entity (Lesson 1) Might Influence the Extent and Focus of the Understanding of Internal Control

Understanding Component	Matter Identified	Possible Risk(s)	Possible Influence on Understanding of Internal Control
Industry, Regulatory, and Other External Factors	A key competitor has introduced products with technology that is superior to several of the client's key products.	• Overvaluation due to obsolescence or lower-of-cost-or-market issues.	• Emphasis on client's risk assessment process relating to inventories. • Detailed understanding of financial reporting system for inventory obsolescence and net realizable value along with key control activities.
Structure, Ownership, Governance, and Related Parties	A new CEO was hired during the year.	• Overall risks at the financial statement level.	• More rigorous risk assessment procedures and additional emphasis on the control environment, risk assessment process, and monitoring.
Nature of the Entity	The client has a new debt facility with onerous debt covenants.	• Misclassification of debt and incomplete related disclosures. • Fraudulent manipulation of accounting records.	• Increased focus and risk assessment procedures relating to the understanding of the control environment regarding management's attitude and ethical values. • Detailed understanding of financial reporting system over debt and key control activities over the review of debt covenants. • Detailed knowledge of the financial reporting process including authorization of journal entries and related key control activities.

Understanding Component	Matter Identified	Possible Risk(s)	Possible Influence on Understanding of Internal Control
Objectives and Strategies and Related Business Risks	The client adopted an objective and strategy to enter a new product area that is technologically complex where it has no previous experience.	• Potential understatement of warranty reserves and/or return reserves.	• Increased focus on the risk assessment process for identifying risks related to new product offerings. • Detailed understanding of financial reporting system and key control activities for estimating warranty and return reserves.
Measurement and Review of the Entity's Financial Performance	A gross profit KPI for a significant new product line is unusually high.	• Potential inventory costing issues.	• Detailed understanding of the financial reporting system and key control activities for inventory, with emphasis on the subsidiary that manufactures and costs the product line.

* * *

Understanding Controls Related to Significant Risks and Risks for Which Substantive Procedures Alone Are Not Sufficient

AU-C 315.30 indicates that the auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement that are considered *significant risks*. Fraud risks are always considered to be significant risks. In addition, significant risks often relate to nonroutine transactions, for example, with related parties, and judgmental matters, such as estimates. Also, revenue recognition issues often pose significant risks. According to AU-C 240.27, after completing risk assessment procedures to evaluate internal control design and implementation, the auditor determines whether a sufficient understanding has been obtained of controls that would prevent, or detect and correct, material misstatements related to fraud risks and other significant risks. If not, the auditor performs additional risk assessment procedures directed at gaining an understanding of controls relating to those risks.

Programs and controls addressing fraud risks or other significant risks may relate to any of the five components of internal control; thus, the auditor needs to use care not to isolate the understanding to only the control activities component. The auditor ought to be alert to the fact that fraud risks or other significant risks may not be subject to routine controls given the nature of the risks. Also, the auditor's understanding extends to whether and how management responds to those risks. Controls that address fraud risks frequently relate to the following:

a. *Control Environment.* Fraud programs designed to prevent, deter, and detect fraud. For example, programs to promote a culture of honesty and ethical behavior.

b. *Control Activities.* Specific controls designed to mitigate specific risks of fraud. For example, controls to address specific assets susceptible to misappropriation.

As with other controls, the auditor evaluates whether the programs and controls that relate to significant risks are suitably designed and implemented and assesses the risks of material misstatement due to error or fraud in light of this evaluation. The existence (or lack) of these programs and controls might either mitigate or increase the risks of material misstatement. The auditor needs to consider the control activities that are relevant to account balances with a significant inherent risk of misappropriation of assets. The risk of misstatement due to fraud for misappropriation of assets always depends on whether there are controls to prevent or detect concealment of theft in the accounting records.

In addition to understanding and evaluating controls related to significant risks, auditors are required by AU-C 315.31 to understand and evaluate controls related to risks for which substantive procedures alone are not sufficient. For those risks, the auditor will have to perform tests of the operating effectiveness of controls to obtain sufficient audit evidence. Therefore, the auditor needs an understanding of the design of relevant controls and confirmation that they have been implemented before he or she can design and perform appropriate control tests.

Effect of Information Technology (IT) on Internal Control

AU-C 315 indicates that auditors should consider how IT affects an entity's control activities. The effects can be extensive, but the effect on the client's internal control is related more to the nature and complexity of the system than to the client's size. Information that may be useful in understanding the effect of IT on internal control includes understanding the role of IT in initiating, authorizing, recording, processing, and reporting transactions. While information systems may use off-the-shelf software packages or custom-developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. How the client manages IT includes understanding the persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.

AU-C 315.22 indicates that in understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. Relevant controls include both properly designed and implemented application controls and the general controls upon which application controls depend. The AICPA Risk Assessment Audit Guide notes in paragraph 4.63 that the auditor evaluates the design of IT general controls and determines whether they have been implemented when assessing the risks of material misstatement. Auditors test general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive procedures. The auditor also ought to be aware that the use of IT may affect the availability of information needed for the audit. Furthermore, in certain situations the auditor may be precluded from using only substantive procedures when the role of IT is significant to the processing of transactions. For example, in highly automated processing with little or no manual intervention when transactions are initiated, authorized, recorded, processed, or reported, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.

Exhibit 2-2 shows some of the ways that information technology affects internal control. The exhibit focuses on the effect of IT on the control environment, information and communication (financial reporting system), and control activities components of internal control. IT can also affect an entity's risk assessment process and procedures, including providing information to assist in identifying and managing risks. In addition, IT may affect an entity's monitoring activities, including providing information used in monitoring. While an entity's use of IT may affect any of the five components of internal control, it seems likely that the effect of IT on the control environment, information and communication, and control activities components of internal control to be more significant for small to midsize nonpublic companies. The effects of IT on the various components of internal control and how IT affects the auditor's procedures are discussed in more detail later in this lesson.

Exhibit 2-2

Examples of IT Aspects of Internal Control

Control Environment

1. Involvement of management or the owner/manager in designing and approving the financial reporting system, including software coding.
2. Involvement of management or the owner/manager in authorizing transactions and approving changes to software coding or data.
3. Involvement of management or the owner/manager in controlling access to and use of software, including coding and data files.

Financial Reporting System

1. The procedures by which transactions are initiated, recorded, processed, and reported.
2. The accounting records, supporting documents, and specific accounts involved in initiating, recording, processing, and reporting transactions.
3. Simple vs. complex IT system; purchased vs. developed software.
4. How data is converted to electronic information.
5. The specific data files accessed and updated.
6. The procedures used to enter transaction totals into the general ledger.
7. The procedures used to initiate, record, and process journal entries.
8. The procedures used to record other financial statement adjustments and to capture other events and conditions significant to the financial statements.

Control Activities

1. User control activities to test the completeness and accuracy of electronically-processed transactions.
2. Application control activities:
   a. Automated control activities, such as edit checks of input data and numerical sequence checks.
   b. Manual follow-up of items on exception reports.
3. General control activities related to:
   a. Acquisition and maintenance of system software.
   b. Acquisition, development, and maintenance of application systems.
   c. Access to programs and data files.
   d. Data center and network operations.

* * *

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors need to consider whether specialized IT skills are necessary to determine the effect of IT on the audit, identify and assess IT risks, understand IT controls, design and perform tests of IT controls or substantive procedures, or identify IT control deficiencies. That determination ought to be made relatively early in the planning process to assure that the

necessary resources are available on a timely basis. AU-C 300.A18 states that auditors may consider the following factors in determining whether the audit team needs to include individuals that possess specialized IT skills:

- Complexity of the entity's systems and IT controls and the manner they are used in the entity's business conduct.
- Significance of changes to existing systems or implementation of new systems.
- Extent to which systems share data.
- Extent of the entity's involvement in electronic commerce.
- Extent of entity's use of emerging technologies.
- Significance of audit evidence available in electronic form only.

An IT specialist may be either a member of the auditor's firm or an outside professional. When an IT specialist is used in the engagement, it may be advisable to include the specialist in the audit team discussions to help design relevant elements of the audit strategy and audit plan, including IT audit objectives, resource needs, and timing.

If the auditor uses an IT specialist on the engagement team, according to AU-C 300.12, the auditor should be knowledgeable enough to communicate the audit objectives to the specialist, evaluate whether the procedures performed by the specialist meet the auditor's objectives, and determine the results of the procedures on the nature, timing, and extent of other planned procedures. That does not mean auditors have to be experts in information technology. The AICPA Risk Assessment Audit Guide at paragraph 3.73 indicates that typically the auditor's responsibility when using an IT specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist, auditors need a basic understanding of IT applications and controls, especially those most relevant to particular client systems. That understanding can be gained from experience with the client or from attending training classes or seminars. The extent of the understanding will vary with the nature of the entity's IT environment.

It seems likely that there could be circumstances when the IT specialist will be considered an auditor's specialist rather than a member of the engagement team. In those cases, the auditor also needs to follow the requirements of AU-C 620, *Using the Work of An Auditor's Specialist*. That guidance requires the auditor to evaluate the specialist's competence, capabilities, and objectivity; obtain a sufficient understanding of the specialist's field; reach agreement with the specialist about the work to be performed; and evaluate the adequacy of the specialist's work.

How Are the Results of the Understanding Used?

The understanding of internal control needs to be sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:

- Identify types of potential material misstatements.
- Consider factors that affect the risks of material misstatement.
- Design tests of controls, when applicable, and substantive procedures.

In addition, the understanding provides audit evidence that contributes to the auditor's planned responses to assessed risks and the performance of further audit procedures. This evidence is an element of the auditor's cumulative audit evidence that ultimately supports the opinion on the financial statements. The auditor remains alert for risks that may be identified during the process of obtaining an understanding of internal controls.

Normally, the auditor's understanding of internal control design and implementation is not sufficient to reach a conclusion on the operating effectiveness of controls. The same types of procedures performed to determine if a control has been implemented (e.g., observation, inspection of documents, reperformance, and walkthroughs) are also used when testing controls for operating effectiveness. However, the extent of the procedures to determine

implementation may fall short of what is needed to determine operating effectiveness because tests of operating effectiveness need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, in some cases, the auditor's procedures may serve both purposes. For example, a walkthrough can serve as a test of operating effectiveness and in some cases, along with other procedures that test operating effectiveness, can provide a valid basis for assessing control risk at less than high. In addition, for an automated control where consistency of application would normally occur assuming the existence of effective IT general controls, the auditor may be able to determine operating effectiveness based on procedures performed to establish that the control has been implemented and the auditor's assessment and testing of the related general controls.

Cybersecurity

Cybersecurity risks have increased as entities have increasingly migrated to use of digital technologies in business and financial operations. Cybersecurity encompasses all IT-related controls in an entity's IT platform that guard against unauthorized access. Cybersecurity risk is the risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

General Effects of Cybersecurity Issues on the Audit. Cybersecurity risks and controls affect the audit of financial statements primarily with respect to the auditor's assessment of the risks of material misstatement of the financial statements, obtaining an understanding of IT controls and their effect on financial reporting and assessing the effect on the financial statements of known cyber incidents. The auditor's concern about cybersecurity relates to data, systems that process that financial-statement-related data, and controls over those systems that could affect the financial statements and the safeguarding of assets in a material way. If certain control deficiencies are identified during the review of the entity's controls relevant to cybersecurity, the auditor should follow the requirements of AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

Inquiries of Management About Cybersecurity Risks and Controls. The auditors' inquiries of management need to include identification of the primary types of sensitive information the entity creates, uses, or stores that is susceptible to cybersecurity risk and management's process for dealing with these risks. Examples of inquiries that may be made include the following:

- The steps management has taken in designing and implementing controls at both the entity and activity level to assess and respond to the risks.
- The steps management has taken to monitor the effectiveness of those controls.
- The internal processes management has designed and implemented for identifying and communicating security events and/or security incidents.
- How management has responded to any security events and/or security incidents.

Engagement Team Discussion on Cybersecurity. In connection with the engagement team discussion, the engagement team needs to discuss the areas in the IT platform relevant to financial reporting that are vulnerable to cyber attacks or intrusion. The discussion could include the following matters:

- What are the primary types of sensitive information that the entity creates, uses, and stores?
- Are the control policies and procedures at both the entity and activity level sufficient to safeguard the integrity of this data?
- How would a cyber attack affect the reliability of the entity's financial reporting or result in a material loss or impairment of the entity's assets?

A Practical Approach for Obtaining an Understanding of Internal Control

Obtaining a sufficient understanding of internal control may appear to be daunting. For many clients, especially smaller nonpublic entities, the auditor may believe, based on the nature of the entity or limited number of

transactions, that the use of substantive procedures alone will be effective and will provide the most efficient or practical means of addressing the identified risks and relevant assertions for significant audit areas. Because an auditor cannot default to a control risk assessment of maximum, however, auditors may have concerns about the depth of understanding of internal control and the extent of risk assessment procedures that will be necessary. For example, auditors may ask questions such as the following:

- Is the same level of understanding necessary for all of the components of internal control?
- How extensive an understanding of entity-level controls is appropriate? How do they relate to control activities?
- What transaction classes or types of transactions are significant for obtaining an understanding of the financial reporting system and related control activities? What is the level of detail of this understanding?
- Is it necessary to be an expert in general IT controls to obtain the understanding needed for the audit?
- What is the most efficient means of obtaining the understanding of internal control?
- How much documentation is needed to describe the understanding?

Most of the answers to those questions—such as answers related to the necessary extent and depth of the auditor's understanding and risk assessment procedures—are ultimately a matter of the auditor's professional judgment.

The key matters that affect the auditor's application of professional judgment in developing an approach for understanding internal control are as follows:

- The understanding of the *five components* of internal control ought to be *sufficient to* (a) *assess the risk of material misstatement* of the financial statements and to (b) *design the nature, timing, and extent of further audit procedures*.
- The understanding ought to be sufficient to allow the auditor to both *evaluate the design of controls relevant* to the audit and to determine *whether they have been implemented*.
- The auditor's understanding of the financial reporting system needs to be sufficient to understand (a) *classes of transactions* that are significant; (b) the procedures and related accounting records for *initiating, authorizing, recording, processing, correcting, transferring to the general ledger, and reporting* those transactions; (c) how significant events and conditions *other than classes of transactions are captured*; (d) the *financial reporting process* used to prepare the financial statements, including significant estimates and disclosures; (e) the controls over journal entries; and (f) the effect of IT on internal control, specifically on control activities that are relevant to the audit.
- The auditor needs to understand and evaluate the following, which may relate to any of the five components of internal control:
  - The design and implementation of controls, including relevant control activities, related to significant risks.
  - The design and implementation of controls, including relevant control activities, related to risks for which substantive procedures alone are not sufficient (i.e., risks requiring tests of controls to obtain sufficient audit evidence).

Auditors of all entities need to obtain an understanding of all five components of internal control and determine whether controls relevant to the audit have been properly designed and implemented. For both large and small entities, fundamental controls, such as reconciliations, management review, and basic input controls, ought to be in place in some form or another. However, the emphasis of the understanding is on assessing the risk of material misstatement of the financial statements due to error or fraud. Thus, the context of the auditor's understanding is

whether internal controls are capable of preventing, or detecting and correcting, what could go wrong in the financial statements, including disclosures, at a material level. Auditors do not need to obtain an in-depth understanding of every control that relates to financial reporting; the risk assessment standards clearly do not require such a detailed approach. Typically, the understanding is much less than would be appropriate for reporting on internal control over financial reporting. However, auditors' understanding ought to be sufficient to allow a proper design of the nature, timing, and extent of further audit procedures.

This course recommends the following approach to assist auditors in efficiently and effectively gaining and documenting a sufficient understanding of internal control. Although the steps are presented sequentially, some of them are interrelated and often performed concurrently with other steps. Steps that this course includes in its approach are as follows:

- Develop an overall strategy for understanding internal control.
- Perform scoping activities.
- Evaluate the design and implementation of entity-level controls, including the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring components of internal control, as well as the IT environment and general IT controls.
- Evaluate the design and implementation of activity-level controls, including the financial reporting system and control activities component of internal control.
- Document the understanding of internal control.

When performing those steps, it is helpful to focus on control objectives and key controls, including segregation of duties. The following paragraphs discuss each of those steps in further detail and provide guidance on considering control objectives and key controls throughout the process.

Develop an Overall Strategy for Understanding Internal Control. As discussed in AU-C 300.09, the audit plan should include a description of the nature and extent of planned risk assessment procedures. This is a critical point; without proper planning, the scope, depth, and documentation of the understanding of internal control may be overly detailed and unnecessary—seriously impacting audit efficiency—or insufficient to address critical factors and controls that will allow the auditor to properly assess the risks of material misstatement. Therefore, the first step in obtaining an understanding of internal control is to develop an overall strategy.

The overall strategy for obtaining an understanding of internal control includes a high level determination of the effect of matters such as the following on the nature and extent of the auditor's risk assessment procedures:

- Previous experience with the client.
- Nature of transactions, diversity of operations, and the client's industry.
- General size, complexity, and sophistication of the client.
- Audits of group financial statements and multiple locations.
- The use of service organizations and outsourced operations.
- The extent and diversity of IT systems.
- Identified risks.
- The extent of client documentation.

The auditor also considers the appropriate amount of time to spend and the assignment of engagement team members in light of the preceding considerations.

Effects of the factors in the preceding paragraph on the auditor's overall strategy for obtaining an understanding of the client's system of internal control may include the following:

- *Previous Experience with the Client*. If the engagement is new, the approach is generally significantly more extensive than for an existing client. For continuing engagements, the auditor's previous experience with the client contributes to the understanding of internal control. To use information from previous audits to support risk assessments in the current audit, the auditor needs to determine whether the information remains relevant. The auditor considers inquiring about changes in transaction types, internal control systems, IT activities, business operations, etc., to help determine where more in-depth risk assessment procedures will be needed.

- *Nature of Transactions, Diversity of Operations, and the Client's Industry*. Based on the nature of transactions and the characteristics of the client's industry, the auditor may expect controls to be more extensive or robust. Also, if the client is subject to legal and regulatory requirements, the auditor may expect additional controls to be in place that address risks associated with such requirements.

- *General Size, Complexity, and Sophistication of the Client*. For small clients, or those with accounting personnel who lack experience or skills in designing and implementing controls, the extent of controls, including proper segregation of duties, may be limited.

- *Audits of Group Financial Statements and Multiple Locations*. In a group audit, different components might be subject to different financial reporting systems and internal controls. Furthermore, in such audits, the auditor may utilize component auditors in performing some or all of the risk assessment procedures relating to the understanding of internal control for components. Similarly, in nongroup audit engagements with multiple locations, different locations might process the same transaction type differently, thereby presenting the possibility of a different level of control risk at each location. Also, when understanding entity-level control components, the auditor needs to be mindful that such controls might operate differently by location. Therefore, depending on the significance of activities and transaction processing at various locations, the auditor may need to perform risk assessment procedures that specifically address controls at each material location (or a selection of locations). The auditor might also consider determining if the client uses a shared-service environment where processing for many locations is handled centrally.

- *The Use of Service Organizations and Outsourced Operations*. Services provided by a service organization are relevant to the audit when the services and the related controls affect the client's financial reporting system. The service organization's services are part of the client's information system, including related business processes, if the services affect: (a) the client's significant classes of transactions; (b) the initiation, authorization, recording, processing, and reporting of client transactions (or other conditions and events) and related accounting records; (c) the process to prepare the client's financial statements; or (d) the controls over journal entries. When obtaining an understanding of the client, the auditor needs to understand how the client uses the service organization in its operations, including (a) the nature and significance of the services provided by the service organization and how they affect the client's internal control, for example, whether the service organization initiates, authorizes, records, or processes transactions, maintains accounting records, or manages the entity's assets; (b) whether the transactions processed or accounts affected by the service organization are significant, either because they are material or because of their nature; (c) the degree of interaction between the client and the service organization, including whether the client has implemented controls over the processing performed by the service organization or relies on controls at the service organization; and (d) the nature of the relationship, including contractual terms, between the client and service organization, for example, whether contractual terms require the service organization to provide a service auditor's report and permit access to records and direct communication by the user auditor if necessary. When significant, the auditor needs to determine the implications for the overall understanding of internal control.

- *The Extent of Use and Diversity of IT Systems*. The extent of IT used in the entity generally affects the auditor's approach to the understanding of internal control and the conduct of risk assessment procedures. Furthermore, to the extent that automated controls are used in the entity, there is an increased likelihood that the auditor will need a more in-depth understanding of general controls. Therefore, it is normally useful

to consider the types of IT environments, significant applications, changes in IT from prior years, and how IT varies among locations. Understanding the IT environment in relation to significant transaction classes and processes, including the financial reporting system, helps the auditor with the decision about whether to use IT specialists for obtaining the understanding, including the understanding of general controls.

- *Identified Risks*. When possible, it is often more efficient to identify inherent risks prior to obtaining the understanding of internal control. This helps ensure that the auditor focuses on controls that address the identified risks of material misstatement when obtaining an understanding of internal control. Furthermore, as previously discussed, the auditor is required to evaluate the design and implementation of controls related to significant risks and risks for which substantive procedures alone are not sufficient. By performing risk assessment procedures relating to the industry, the client, and its environment prior to obtaining the understanding of internal control, the auditor normally has a better idea of the significant risks to be considered. (However, the auditor needs to be aware that additional risks of material misstatement may be identified when obtaining the understanding of internal control or when performing further audit procedures.)

- *The Extent of Client Documentation*. Some clients, typically larger entities, may have well defined documentation of their system of internal control. Documentation may be available in policies and procedures manuals, departmental procedure memos, employee handbooks, job descriptions, and similar documents. While the existence of documented procedures and controls does not relieve the auditor of the requirement to perform risk assessment procedures to obtain an understanding of relevant controls (including evaluating design and determining that controls are implemented), good client documentation often significantly aids the efficiency of the understanding and evaluation of the design of controls and generally reduces the effort in meeting documentation requirements. (In some cases, the auditor may want to encourage clients to prepare basic documentation of their processes and control systems to improve audit efficiency.) A word of caution: do not assume that just because written documentation exists, the processes and controls have been implemented as described. If the client lacks documentation, including documentation that evidences performance of a control, the auditor might consider how this will impact the conduct of risk assessment procedures and whether there will be sufficient evidence to evaluate the design and implementation of controls. According to the AICPA Risk Assessment Audit Guide (paragraph 4.38), if the client does not document a control, that may represent a control deficiency. However, the auditor may document the control as part of the risk assessment procedures to identify and assess the risks of material misstatements. If the client fails to document the performance of a control, for example, by initialing that it has been done, inquiry and observation may not provide sufficient evidence that the control is in place and operating. In some cases, the absence of documentation may be a control deficiency and could possibly rise to the level of a significant deficiency or material weakness.

By considering the factors in the previous paragraph, the auditor is better able to (a) identify the internal control components, classes of transactions, and disclosures that require emphasis when obtaining the understanding and (b) consider the nature and extent of risk assessment procedures that are necessary. Also, developing an overall strategy for understanding internal control allows for more effective assignment of engagement personnel. For example, if the auditor expects controls over revenue transaction processing to be complex, more experienced staff might be assigned, allowing newer staff to address less complex areas such as cash disbursements. Furthermore, the plan for obtaining the understanding of internal control often suggests the nature and extent of auditor documentation that would be appropriate. For example, a relatively simple information system, and its related control activities, might be documented using narrative format. A complex processing environment with numerous data inputs and outputs and extensive control activities might be easier to comprehend and follow if documented through the use of a flowchart.

Perform Scoping Activities. After developing an overall strategy for obtaining and documenting the understanding of internal control, the auditor performs scoping activities to further direct his or her efforts. The auditor's scoping activities can be effectively accomplished by using the "top-down" approach.

The Top-down Approach. The "top-down" strategy, or approach, to understanding internal control begins at the financial statement level and works down to the individual activity control level. Using the top-down approach can improve audit effectiveness and efficiency in scoping the audit because it focuses on those controls related to

relevant assertions for material accounts and significant classes of transactions. The following summarizes the application of the top-down approach.

- Gain an understanding of the overall risks of material misstatement at the financial statement level.
- Identify the material accounts and classes of transactions that are significant to the financial statements and the relevant assertions related to those accounts.
- For each relevant assertion identified, consider the risks of material misstatement, that is, what can go wrong.
- Identify control objectives related to the assertion that addresses the risks.
- Identify those controls (key controls) that mitigate the risks that the control objectives will not be achieved.

By identifying material accounts and disclosures along with the relevant assertions, the auditor is better able to focus on controls affecting audit areas that present a reasonable possibility of material misstatement. When identifying material accounts, the auditor generally considers planning materiality, as discussed in Lesson 3, but also considers other factors such as the nature of the account, its susceptibility to misstatement, the types of transaction classes affecting the balance and their volume, identified risks, and similar factors. For example, an accounts payable balance may not be significant based on a consideration of quantitative materiality, but the risk of material misstatement due to unrecorded liabilities might justify considering it as a material account. Identifying relevant assertions for material accounts and disclosures allows the auditor to identify and consider the control objectives and underlying key controls that address the risk of "what could go wrong" in those areas.

AU-C 315.19 indicates that the auditor is required to obtain a sufficient understanding of the financial reporting system to understand the classes of transactions that are significant and the procedures for initiating, authorizing, recording, processing, correcting, transferring to the general ledger, and reporting those transactions. *Significant transaction classes* are those classes of transactions in the entity's operations that are significant to the financial statements, generally because of the volume or risk characteristics of transactions processed. The scope of the auditor's risk assessment procedures includes obtaining an understanding of the flow of transactions for all significant transaction classes. It is not necessary to perform risk assessment procedures to understand transaction classes that are not significant.

When determining significant transaction classes, the auditor normally considers the components and business locations where transaction classes are processed as well as the IT environments that affect transaction processing. Identifying significant transaction classes is discussed further later in this lesson.

The scoping process does not need to be overly detailed or complicated. The approach that an auditor might follow to address the items in the top-down approach depends on the size and complexity of the client's operations. The important point is that the auditor needs a clear vision of what is significant at the entity before embarking on the process of obtaining an understanding of internal control.

Evaluate the Design and Implementation of Entity-level Controls. Auditors may be tempted to focus first on the information systems and related control activities since those components are directly related to the assertions that are relevant to the financial statements. However, as discussed later in this lesson, the auditor normally obtains an understanding of the control environment and other entity-level controls prior to considering activity-level controls. The reason for this "top-down" approach is fairly straightforward—entity-levels controls may have a pervasive effect on other controls; therefore, entity-level controls ought to be understood first. In addition, entity-level controls typically influence how the auditor evaluates other controls. For example, if the control environment is weak, the potential benefit of good control activities may be negated because management might be more likely to override controls. In this case, although the auditor still needs to understand control activities, it is unlikely that the auditor would plan on testing controls. Also, weaknesses in pervasive entity-level controls may present a risk at the financial statement level. Auditing standards require the auditor to assess risks at the financial statement level and develop an overall response, and considering these controls early in process, the auditor is in a better position to plan and apply the overall response determined to be necessary.

Some entity-level controls, such as effective monitoring controls, might be directly linked to preventing or detecting material misstatements at the relevant assertion level for an account balance, transaction class, or disclosure. In that case, the auditor might consider the impact of the entity-level control, in addition to related control activities, when assessing control risk for the relevant assertion for the audit area.

Controls throughout the system may be either manual or automated and may be significantly affected by IT. Therefore, the auditor also obtains an understanding of the entity's IT environment and general IT controls when obtaining an understanding of entity-level controls. Evaluating the design and implementation of entity-level controls is discussed later in this lesson.

Evaluate the Design and Implementation of Activity-level Controls. As discussed above, the auditor ordinarily obtains an understanding of entity-level controls first because those controls have a pervasive effect on the entity's financial statements. Also, the auditor generally accumulates a significant amount of knowledge about activity-level controls through the understanding of entity-level controls. After obtaining an understanding of entity-level controls, the auditor focuses on obtaining an understanding of the financial reporting system, which is part of the information and communication component of internal control. Obtaining an understanding about how the entity initiates, authorizes, records, processes, and reports transactions through the financial reporting system typically also provides a significant amount of information about control activities. After obtaining an understanding of those aspects of transaction processing, the auditor considers whether it is necessary to devote additional attention to obtaining an understanding of control activities. Evaluating the design and implementation of activity-level controls is discussed later in this lesson.

Document the Understanding of Internal Control. AU-C 315.33 requires documentation of the understanding of the entity and its environment, including internal control. For internal control, the auditor is required to document the understanding obtained for each of the five components of internal control listed at the beginning of this lesson. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

Historically, auditors have documented their understanding of internal control using a variety of methods. These methods have included:

- Narratives or memorandum documents.
- Internal control questionnaires.
- Checklists.
- Flowcharts.

AU-C 315 permits auditors flexibility in the manner of documentation. The form and extent of documentation is influenced by factors such as the complexity, size, and nature of the entity and the use of technology. Where applicable, some auditors supplement their documented understanding with existing documentation of control systems prepared by the entity. Due to the increasing visibility of the importance of controls, many entities have developed or enhanced their internal documentation and evaluation of internal controls. Auditors may consider inquiring of the client about the existence of such documentation along with any supporting evaluation of the effectiveness of controls. In those cases, the auditor may gain additional audit efficiencies and a better understanding of the client's internal control.

Considering Control Objectives/Principles and Key Controls

Control Objectives and Principles. When obtaining an understanding of internal control, many auditors consider *control objectives* during the process of identifying controls and evaluating their design and implementation. A control objective states the purpose of a control (or controls) in relation to risks and "what could go wrong" in the financial statements. For example, "All property, plant, and equipment additions are recorded," might be a control objective that addresses a risk of fixed asset transactions not being properly tracked and recorded (i.e., completeness). Failure to achieve that control objective could potentially result in understatement of fixed assets and depreciation expense, as well as misstatements in other income statement accounts.

The term *control objectives* in this course is commonly used in connection with controls relating to the account balance, transaction class, or disclosures, as well as to general IT controls. For entity-level controls, such as control environment and monitoring controls, this course refers to *principles* instead of control objectives. These principles are adapted from COSO's 2013 updated *Internal Control—Integrated Framework*. Principles represent the fundamental concepts associated with each component of internal control. The COSO principles are concise statements that compress important internal control ideas and concepts into a few words and that give direction to implementation. For example, within the component of the control environment, the element of "communication and enforcement of integrity and ethical values" (discussed later in this lesson) is replaced with the principle, "the entity demonstrates a commitment to integrity and ethical values," which provides greater understanding of the goal to be achieved. Another example that illustrates how the use of principles adds clarity and explanation is the replacement of the element of "organization structure" with the principle, "With board oversight management establishes structure, reporting lines, and appropriate authorities and responsibilities to achieve financial reporting objectives." (Exhibit 2-3 lists principles for the control environment.)

Similar to control objectives, if a principle is not present and functioning at the entity, a risk could exist where something could go wrong in the financial statements. For example, if the principle of "The entity demonstrates a commitment to integrity and ethical values," is not present and functioning at an entity, there is a risk at the financial statement level that misstatements could occur throughout the financial statements primarily due to fraud.

By considering control objectives (and principles) and how they relate to risks and what can go wrong at the relevant assertion level, an auditor might find it easier to identify existing controls and evaluate their design effectiveness. For example, an auditor might tailor inquiries of client personnel to focus on how certain control objectives are achieved within the entity when trying to identify the controls that address a particular risk of material misstatement. Likewise, when existing controls are identified, the auditor can evaluate whether those controls, if operating effectively, would fully achieve the objective or whether deficiencies exist because of improper design or missing controls.

Key Controls. As indicated in AU-C 315.21, the auditor is not required to understand all controls and control activities that might exist in an entity. The auditor typically focuses attention on those controls that are most important in achieving particular control objectives (and principles) related to identified risks. Often, an entity has multiple controls that contribute to achieving its control objectives. However, certain of those controls, referred to as *key controls*, are considered primary to achieving the objectives. When identifying controls, evaluating design effectiveness, determining implementation, and, if applicable, testing operating effectiveness, it is often most efficient and effective for the auditor to focus on *key controls*. Many times, these are the controls that the client believes are the most effective and reliable in operation to fully address a control objective. Key controls are important because their failure could materially affect the relevant assertion but might not be detected in a timely manner by other controls. Key controls are also important because their operation might prevent, or detect on a timely basis, other control failures that would be material to the entity's objectives. Often, especially for smaller entities, management review (i.e., monitoring) controls are key. When determining which controls are key, the auditor might consider factors such as:

- The nature of the risks being addressed.
- The characteristics of related account balances or transaction classes.
- Whether the control is preventive (i.e., prevents misstatements) or detective (i.e., detects misstatements).
- Whether the control works in combination with or relies on the operation of other controls.
- Whether the control is manual or automated.
- Whether the control addresses more than one control objective.
- The nature and type of potential misstatements that the control would prevent, or detect and correct (i.e., would misstatements most likely arise from error, fraudulent financial reporting, or misappropriation of assets?).

Do Not Forget about Indirect Controls and Controls over Spreadsheets. In some cases, the effectiveness of a key control directly related to an assertion depends on the proper operation of other, or indirect, controls. Auditors may make an erroneous assessment of control risk if the role of indirect controls is not considered during the understanding and evaluation of controls. For example, if daily customer orders are approved on an exception basis by the sales manager by reviewing a printout of those customer orders that do not meet standard pricing and terms, the auditor ought to consider performing risk assessment procedures directed to the completeness and accuracy of the exception report.

Client-prepared spreadsheets are often an important part of a client's information system. In many cases, information may be generated by a packaged software module and then further processed or recorded in a spreadsheet prepared by accounting personnel. In many instances, the creation of a spreadsheet template is not subject to any formal controls, including verifying the integrity of key formulas. When spreadsheets are an important part of the information system or support the performance of a key control activity, the auditor's understanding normally needs to encompass the controls over those spreadsheets.

Consider Segregation of Duties. When obtaining an understanding of the entity's processes related to financial reporting and their associated control activities, the auditor considers proper segregation of duties. AU-C 315.A99 specifically notes segregation of duties as an example of a control activity. Without proper segregation of duties, the design of controls may be deficient because individuals may be in a position to perpetrate and conceal errors or fraud when performing their job functions. In many cases, auditors isolate the initiation, authorization, processing, and recording functions and then determine the actual personnel who perform those functions to ascertain if any incompatibility exists.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the following statements best describes an aspect of the auditor's understanding of internal control?

    a. The COSO's *Internal Control—Integrated Framework* (the COSO framework) will not help with the audit of a small, nonpublic entity.

    b. The understanding of internal control needs to be sufficient for the auditor to assess the risk of material misstatement due to error or fraud and design further audit procedures.

    c. The extent of the understanding of internal control is spelled out in the auditing standards and must be adhered to.

    d. An auditor's main focus is to determine whether a documented control has been designed effectively.

11. Significant risks are often related to which of the following?

    a. Routine transactions.

    b. Fraud risks.

    c. Information technology (IT).

    d. Key controls.

12. An auditor's concerns about cybersecurity typically relate to what?

    a. The complexity of the entity's systems and the significance of changes to existing systems.

    b. The auditor's understanding of the components of internal control and the financial reporting system.

    c. Whether the auditor will rely on IT application controls to modify substantive procedures.

    d. Financial statement data, the systems that process it, and controls over the systems.

13. Which of the following guidance applies to the auditor's overall strategy for obtaining an understanding of the entity's internal control?

    a. The approach must be more extensive for existing clients to incorporate skepticism.

    b. The extent of controls will be similar despite the size of the client's operations.

    c. It is best to identify risks prior to obtaining the understanding of internal control.

    d. Services outsourced to a service organization are outside the scope of the understanding.

14. Key controls do which of the following?

    a. Have little effect when they fail.

    b. Can prevent other control failures.

    c. Need little attention from the auditor.

    d. Work manually to prevent misstatements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the following statements best describes an aspect of the auditor's understanding of internal control? **(Page 179)**

    a. The COSO's *Internal Control—Integrated Framework* (the COSO framework) will not help with the audit of a small, nonpublic entity. [This answer is incorrect. Although small, nonpublic entities may not have formally adopted or even be familiar with the COSO framework, it is still a good idea for auditors to turn to the COSO framework as a reference and guide for understanding and evaluating internal control as it relates to their clients.]

    b. The understanding of internal control needs to be sufficient for the auditor to assess the risk of material misstatement due to error or fraud and design further audit procedures. [This answer is correct. The overriding criterion for the understanding of internal control is that it be *sufficient* to assess the risk of material misstatement of the financial statements due to error or fraud and to design nature, timing, and extent of further audit procedures. Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor develop a fairly thorough and robust knowledge of all five of the components of internal control.]

    c. The extent of the understanding of internal control is spelled out in the auditing standards and must be adhered to. [This answer is incorrect. Because the extent of understanding of internal control is a matter of professional judgment (not a qualitative measure outlined in the auditing standards), auditors will often struggle over what controls or combinations of controls to assess.]

    d. An auditor's main focus is to determine whether a documented control has been designed effectively. [This answer is incorrect. It is *not* enough to simply determine whether a control as described or documented is effective in design. The documentation of a control procedure does not demonstrate that the control is actually being used. The auditor, therefore, also needs to determine if the control, as documented or described, actually exists and the entity is using it.]

11. Significant risks are often related to which of the following? **(Page 182)**

    a. Routine transactions. [This answer is incorrect. Significant risks are more likely to relate to *nonroutine* transactions than routine transactions. Some examples include related-party transactions and transactions related to judgmental matters, such as estimates.]

    b. Fraud risks. [This answer is correct. AU-C 315.30 indicates that the auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement that are considered *significant risks*. Fraud risks are always considered to be significant risks; though there are other risks that can fall into this category, as well.]

    c. Information technology (IT). [This answer is incorrect. AU-C indicates that auditors should consider how IT affects an entity's control activities; however, IT is not exclusively related to significant risks. Therefore, there is a better answer to this question.]

    d. Key controls. [This answer is incorrect. Key controls are important to the understanding of internal control, as described in AU-C 315.21; however, key controls are a separate consideration from significant risks and should be treated as such.]

12. An auditor's concerns about cybersecurity typically relate to what? **(Page 186)**

    a. The complexity of the entity's systems and the significance of changes to existing systems. [This answer is incorrect. AU-C 300.A18 states that auditors may consider certain factors in determining whether the audit team needs to include individuals that possess specialized IT skills. Two of those factors are (1) the complexity of the entity's systems and IT controls and the manner they are used in the entity's business conduct and (2) significance of changes to existing systems or implementation of new systems. However, the determination of whether an IT specialist is needed is separate from the auditor's understanding of cybersecurity.]

    b. The auditor's understanding of the components of internal control and the financial reporting system. [This answer is incorrect. There are several key matters that affect the auditor's application of professional judgment in developing an approach for the understanding of internal control, and the two items listed in this answer choice are part of those key matters. However, this understanding is separate from the auditor's concerns about cybersecurity.]

    c. Whether the auditor will rely on IT application controls to modify substantive procedures. [This answer is incorrect. Auditors test general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive procedures. The auditor also ought to be aware that the use of IT may affect the availability of information needed for the audit. However, whether the auditor will rely on IT for this use is different from the auditor's concerns related to cybersecurity.]

    d. Financial statement data, the systems that process it, and controls over the systems. [This answer is correct. Cybersecurity encompasses all IT-related controls in an entity's IT platform that guard against unauthorized access. The auditor's concern about cybersecurity relates to data, systems that process that financial-statement-related data, and controls over those systems that could affect the financial statements and the safeguarding of assets in a material way.]

13. Which of the following guidance applies to the auditor's overall strategy for obtaining an understanding of the entity's internal control? **(Page 189)**

    a. The approach must be more extensive for existing clients to incorporate skepticism. [This answer is incorrect. If the engagement is new, the approach is generally significantly more extensive than for an existing client. For continuing engagements, the auditor's previous experience with the client contributes to the understanding of internal control.]

    b. The extent of controls will be similar despite the size of the client's operations. [This answer is incorrect. For small clients, or those with accounting personnel who lack experience or skills in designing and implementing controls, the extent of controls, including proper segregation of duties, may be limited.]

    c. It is best to identify risks prior to obtaining the understanding of internal control. [This answer is correct. When possible, it is often more efficient to identify inherent risks prior to obtaining the understanding of internal control. This helps ensure that the auditor focuses on controls that address the identified risks of material misstatement when obtaining an understanding of internal control.]

    d. Services outsourced to a service organization are outside the scope of the understanding. [This answer is incorrect. Services provided by a service organization are relevant to the audit when the services and related controls affect the client's financial reporting system. Outsourced services cannot be dismissed out of hand when obtaining an appropriate understanding of internal control.]

14. Key controls do which of the following? **(Page 193)**

    a. Have little effect when they fail. [This answer is incorrect. Key controls are important because their failure could materially affect the relevant assertion but might not be detected in a timely manner by other controls.]

    b. Can prevent other control failures. [This answer is correct. One reason key controls are important is that their operation might prevent, or detect on a timely basis, other control failures that would be material to the entity's objectives.]

    c. Need little attention from the auditor. [This answer is incorrect. The auditor typically focuses attention on more important key controls; the auditor would not give such controls less attention.]

    d. Work manually to prevent misstatements. [This answer is incorrect. When determining which controls are key, auditors consider several factors, including whether the control is preventative or detective and whether it is manual or automated. However, key controls would not always be one or the other.]

ENTITY-LEVEL CONTROLS

This course refers to the internal control components of the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-level" or "company-level" controls. These controls typically have a pervasive effect on the entity's system of internal control and can, therefore, potentially influence the design and operating effectiveness of other controls. Also, the auditor generally accumulates a significant amount of knowledge about activity-level controls (which are discussed later in this lesson) through the understanding of entity-level controls. As a result, it is a best practice for auditors to obtain an understanding of the entity-level control components first, beginning with the control environment. The IT environment and general IT controls also have a pervasive effect and are considered at the entity level. This section discusses each of the entity-level control components in depth.

Control Environment

What Is the Control Environment? The control environment sets the tone of an entity and influences the control consciousness of its people. The control environment is the foundation for all other components of internal control and provides structure and discipline. Among the important elements of the control environment are the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control.

According to AU-C 315.A79, the elements of the control environment that may be relevant when understanding the control environment include—

- Participation of those charged with governance.
- Communication and enforcement of integrity and ethical values.
- Management's philosophy and operating style.
- Organizational structure.
- Human resource policies and procedures.
- Assignment of authority and responsibility.
- Commitment to competence.

An entity's control environment is a significant factor when considering the risks of material misstatement due to error or fraud. The integrity of management or the owner/manager often plays a significant role in establishing a strong control environment. Accordingly, AU-C 315.15 requires the auditor, when obtaining an understanding of the control environment, to evaluate whether management and those charged with governance have created and maintained a culture of honesty and ethical behavior. For example, although an entity might not have a written code of conduct, it might still have a culture that emphasizes the importance of integrity and ethical behavior. That culture will be instilled through the visibility and direct involvement of the owner/manager or top management. Obtaining an understanding of the control environment of a small or midsize nonpublic company need not be a complex process. The term is more formal and imposing than the idea behind it. The control environment is simply the conditions and circumstances that exist within the entity that demonstrate management's attitude about controls and other indicators of management's integrity and motivation.

The auditor generally obtains a sufficient knowledge of the control environment as a result of performing risk assessment procedures to understand the attitudes, awareness, and actions of management and those charged with governance concerning internal control and its importance in achieving reliable financial reporting. The auditor should evaluate whether the control environment elements collectively provide support for the other components of internal control and whether those other components are undermined by deficiencies in the control environment. The responsibilities assumed by management and those charged with governance related to financial reporting are particularly important. For example, the auditor might identify the members of management, and directors if any, who are expected to understand the entity's business transactions and to evaluate whether they are

appropriately reflected in the financial statements. The auditor considers both (a) the aspects of the control environment that help insure the integrity of financial reporting (that is, the key control environment controls) and (b) any control environment weaknesses that could have a pervasive effect on the financial statements.

Principles. As previously discussed, this course provides principles that represent the fundamental concepts associated with each entity-level component of internal control. Auditors may consider these principles during the process of identifying controls and evaluating their design and implementation. These COSO principles, shown in Exhibit 2-3, incorporate the control environment elements discussed above.

Exhibit 2-3

Control Environment—COSO Principles

- The entity demonstrates a commitment to integrity and ethical values.
- The board of directors/those charged with governance demonstrates independence from management in exercising oversight of the development and performance of internal control over financial reporting.
- With oversight from the board of directors/those charged with governance, management establishes structures, reporting lines, and appropriate authorities and responsibilities to achieve financial reporting objectives.
- The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with financial reporting objectives.
- The entity holds individuals accountable for their internal control responsibilities.

* * *

Risk Assessment Procedures and Factors to Consider. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures. Auditing standards place an emphasis on corroborating management's and employees' responses to inquiries through observation or inspection. For example, through inquiries of management and employees, the auditor obtains an understanding of management's commitment to ethical values and competence. The auditor follows through with observation of the behavior and attitude demonstrated by management in managing the business.

The audit evidence for the control environment is often not available in documentary form. When it is available, the auditor may inspect documents, for example, a written code of conduct, as evidence of how management communicates its views of business practices and ethical behavior. While formal documentation may be preferable, it is not always necessary in order for a policy to be in place and operating effectively. This is emphasized in a nonauthoritative AICPA Technical Question and Answer, *Obtaining an Understanding of the Control Environment* (Q&A 8200.08). Q&A 8200.08 notes that if an auditor decides to rely on these controls (whether documented or not), it is necessary to test the controls. For example, in a small business, human resource policies may not be formally documented as they would be in a larger entity. Even so, policies and practices can still exist and be communicated orally. When documentary evidence is not available, the auditor might observe management's and directors' actions and attitudes. When the client's documentation is minimal, the auditor may need to provide more robust documentation of his or her understanding of the control environment to serve as a basis for determining the nature, timing, and extent of further audit procedures.

Exhibit 2-4 provides examples of possible risk assessment procedures that could be used when evaluating the design and implementation of the control environment.

Exhibit 2-4

Examples of Risk Assessment Procedures for Evaluating Design and Implementation—Control Environment

Illustrative Risk Assessment Procedures	
Evaluating Design	**Determining Implementation**
• Inquiries of management and board members regarding functions of the board. • Review of backgrounds, relationships, affiliations, and experience of the board and internal audit.	• Review of board's charter and minutes on the nature of board actions. • Review minutes of the audit committee. • Review of internal audit reports.
• Inquiry of management about communication and enforcement actions and processes. • Review of general policy statements on ethical values.	• Inquiry of other personnel regarding communication received on ethical values. • Discussion with human resources regarding actions taken on ethics violations. • Review of written communications issued to employees; for example, employee acknowledgement forms signed upon hiring regarding ethical behavior or code of conduct. • Observation of management's behavior in managing the business.
• Inquiry of management regarding philosophy on accounting, reporting, and establishment of controls. • Inquiry of management regarding the amount of risk the entity is willing to accept.	• Inquiries of accounting personnel to corroborate the general control environment and importance of financial reporting within the organization. • Review of communication issued by management to personnel regarding issues that relate to financial reporting. • Review of internal audit reports and prior year communication of internal control related matters for items that indicate issues with management's philosophy or style. • Review of policies and procedures manuals to determine the extent and quality of controls. • Observation of management's behavior and decisions regarding accounting matters.
• Review of organizational charts. • Inquiry of management regarding the functions and responsibilities within organizational lines and key positions. • Inquiry of management regarding organizational ownership of key financial data.	• Inquiry of key functional and department leaders regarding roles and adequacy of the organizational structure. • Inquiry of financial reporting staff regarding the effectiveness of communication within the organization in reporting financial events and transactions.
• Inquiry of human resources leadership (or role that is responsible for HR) on turnover and hiring, training, and evaluation practices. • Inquiry of human resources leadership on how employees receive communication on integrity and ethical values. • Review of HR policy and procedure manuals.	• Review of personnel files for documentation of hiring, training, and evaluation history. • Inquiry of employees on communication of ethical values, training and evaluation. • Observation of turnover in accounting department.

Illustrative Risk Assessment Procedures	
Evaluating Design	**Determining Implementation**
• Inquiry of management and department leadership regarding roles, responsibilities, and authorization. • Review of organization charts.	• Inquiry of employees corroborating management responses. • Review of information contained in policy/procedures manuals and written job descriptions. • Transaction walkthroughs of the documented financial reporting systems to determine whether authorization controls are properly established. • Observation of the roles and responsibilities that are occurring within the entity.
• Inquiry of management and human resources on competence requirements for key jobs, especially finance and accounting. • Review of job descriptions and requisite requirements for key positions. • Inquiry of management and human resources regarding the adequacy of staffing in departments that impact financial reporting.	• Inquiries of employees that hold key positions regarding their experience, training, and education. • Review of personnel files for employees that hold key jobs. • Review of internal audit reports for issues that relate to competence of employees. • Review of prior year audit adjustments and communications of internal control matters for items that relate to competence of accounting personnel. • Review of employee turnover reports and unfilled job requisitions during the year.

* * *

Considering Management Control Consciousness. Management has to take the lead in creating an atmosphere of control consciousness. If management has a high regard for maintaining reliable accounting records and adhering to established policies and procedures, then employees are likely to be more conscientious in performing their duties. Similarly, if management's attitude is cavalier and conveys a disregard for sound practices, then employees are likely to be careless in discharging their responsibilities. In extreme cases of lack of control consciousness, accounting records may be so undependable that the company is unauditable. The control consciousness of management or the owner/manager can have an important influence on the extent of detailed testing of the accounting records that is necessary.

Small Business Considerations. The influence of an owner/manager predominates in a small business. Consideration of owner/manager integrity is an important factor in deciding whether to accept a small business engagement. Factors such as the owner/manager's tendency to take unusual or unnecessary business risks may increase audit risk. In preliminary planning, an auditor needs to reconsider the background information on owner/manager integrity along with the knowledge that has been obtained about the client's business, its operations, and its industry.

The purpose of the auditor's reconsideration is to assess whether the attitude of the owner/manager in the particular circumstances might create an increased risk of material misstatement of the financial statements. An owner/manager, because of the ability to dominate activities or override controls, is in a position to execute and conceal improper transactions. Even a basically honest owner/manager may be motivated in some cases to materially misstate the financial statements, and an auditor needs to recognize these circumstances and consider them in planning, especially when identifying risks of material misstatement of the financial statements due to fraud.

Some of the circumstances that increase the risk of material misstatement of the financial statements of a small business because of their effect on the owner/manager's attitude are:

a. An interest in employing inappropriate means to minimize reported earnings (for example, by reducing income or charging personal expenses to the business) for tax-motivated reasons.

b. A threat to the owner/manager's personal net worth when the owner/manager has personally guaranteed significant debts of the company.

c. Pressure to obtain additional capital in order to stay competitive.

d. A significant pending transaction (such as a financing arrangement) that could be adversely affected if poor financial results are reported.

Several of these are fraud risk factors as discussed in Lesson 1.

The control environment for smaller entities will generally be different than that necessary for a larger entity. The active involvement of an owner-manager may mitigate risks arising from the lack of segregation of duties often found in a small entity, as noted below. COSO's *Internal Control—Integrated Framework* indicates that a characteristic of the board of directors' oversight responsibilities is a sufficient number of members who are independent of management. However, it notes that nonpublic entities may find it costly or difficult to attract competent independent directors. It further notes that in those rare cases where an independent board is not possible, different processes and controls should be established to obtain adequate oversight. In an owner-managed business, the absence of outside directors on a client's board may not necessarily increase the risk of material misstatement or indicate an internal control deficiency to be communicated to management and others when the owner-manager is actively involved in the governance of the entity. In a small business environment, it is a best practice for auditors not to place undue reliance when "independent" directors exist. In many small businesses, such directors can be close friends or associates of the business owner and may have their objectivity impaired.

In addition, audit evidence for elements of the control environment in a smaller entity may not be found in documentary form. For example, due to the owner-manager's active involvement, communication between management and personnel may be informal but yet result in an effective control environment.

Effect of the Control Environment in Assessing Risk. The existence of a satisfactory control environment, or the lack of such an environment, is an important factor in assessing the risks of material misstatement at the financial statement level. For this purpose, the auditor concentrates on the collective effect of the strengths and weaknesses in the control environment on the risks of material misstatement. That assessment usually affects decisions and judgments made in establishing the overall audit strategy. For example, weaknesses in the control environment might cause the auditor to perform more substantive procedures as of the balance sheet date rather than at an interim date or to use only substantive procedures in more audit areas. Also, while a strong control environment may not completely eliminate the risk of fraud due to the limitations of internal control, it may help reduce the risks of fraud.

As indicated at the beginning of this discussion, the auditor normally obtains an understanding of the control environment prior to other components of internal control. The reason for this is fairly straightforward—the strengths or weaknesses in the control environment (an entity-level control) normally have a permeating effect on the remainder of the control components. For example, if management demonstrates a poor attitude toward the need for a strong accounting and reporting function, the chances of the company having robust risk assessment, information and communication, monitoring, and control activities are significantly reduced.

In a smaller entity, a strong control environment can partially compensate for control deficiencies in other areas, including inadequate segregation of duties. The control environment is often viewed synonymously with "tone at the top." Employees of smaller businesses often interact with management and typically are influenced by the tone at the top. Consequently, smaller entities often develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. In small recurring business audits, the auditor may often develop an understanding of this culture and, thus, the control environment, through the collective interaction with management and employees. Therefore, many auditors of smaller businesses are able to articulate the control environment without exhaustive testing.

Due to the role of the control environment, the auditor's understanding of this area may influence how the auditor approaches obtaining an understanding of other areas of internal control, as well as the ultimate assessment of risk at the overall financial statement level. Risk at the overall financial statement level is discussed later in this lesson.

Effect of Information Technology on the Control Environment. Exhibit 2-2 shows some of the ways that information technology affects the control environment. The auditor's consideration of those factors can be documented when documenting an understanding of the control environment.

Documentation of the Control Environment. The auditor's understanding of the entity's control environment can be documented, along with the sources of information and procedures performed to obtain or update the understanding. The form allows the auditor to document the understanding of the control environment by considering the principles discussed in Exhibit 2-3 and provide an overall conclusion regarding whether the control environment is properly designed and implemented considering the overall size and complexity of the entity.

Risk Assessment

Risk assessment is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives. With respect to the objective of reliable financial reporting, the entity's risk assessment process involves the identification, analysis, and management of the risks of material misstatement of the financial statements. An entity's risk assessment process includes the following:

- Financial reporting objectives.
- Management of financial reporting risks.
- Consideration of fraud risk.
- Consideration of changes that could impact internal control.

The auditor generally obtains sufficient knowledge of management's risk assessment process as a result of applying risk assessment procedures to understand how management considers risks relevant to reliable financial reporting objectives and decides about actions to address those risks. In some cases there will be a formal risk assessment process, but a formal process is not essential. The auditor should obtain an understanding of the following issues:

a. How does management identify business risks relevant to financial reporting?

b. How does management estimate the significance of the risks?

c. How does management assess the likelihood of their occurrence?

d. How does management decide on actions to manage the risks?

The auditor concentrates on the effectiveness of management's efforts to identify and deal with the risks of material misstatements in financial reporting. The auditor considers both (a) the aspects of the entity's risk assessment process that enable management to identify, analyze, and address business risks and (b) any difficulties in identifying and addressing those risks.

Risks relevant to material misstatements in financial reporting include internal and external events and circumstances that adversely affect an entity's ability to appropriately initiate, authorize, record, process, and report financial data. Risks are affected by events and circumstances such as the following:

a. Changes in operations.

b. New personnel.

c. New or revised information systems.

d. Rapid growth.

e. New technology.

f. New business models, products, or activities.

g. Corporate restructurings.

h. New accounting standards.

AU-C 315.17–.18 require the auditor to obtain an understanding of both the entity's risk assessment process and the results of that process. If the auditor identifies risks of material misstatement that the entity did not identify, the auditor should evaluate whether the entity's risk assessment process failed and, if so, why the process failed and whether the process is appropriate in the circumstances or contains a significant deficiency or material weakness. If the entity lacks a formal risk assessment process, the auditor should discuss with management whether risks relevant to financial reporting have been identified and how they were addressed. The auditor should also evaluate whether the lack of a documented process is appropriate for the entity or represents an internal control deficiency that needs to be evaluated to determine whether it is a significant deficiency or material weakness.

Note that risk assessment as described in AU-C 315.16–.18 is not the same as an auditor's consideration of audit risk (inherent risk, control risk, and detection risk) in a financial statement audit. An auditor assesses inherent and control risks to evaluate the likelihood that the financial statements could be materially misstated. An entity's risk assessment, on the other hand, is the process of identifying, analyzing, and managing risks that affect the entity's objectives. However, this course suggests that management's risk assessment process, as it relates to financial reporting, is somewhat similar to the auditor's assessment of inherent risk. That is, it involves management identifying potential areas of misstatement in the financial statements, including misstatements due to fraud. Management then implements control activities or takes other steps as necessary to prevent or detect such misstatements.

Auditors may be able to leverage the client's documentation when obtaining and documenting their understanding of the client's risk assessment process. However, even when the client has adequate documentation of its risk assessment process, the auditor still needs to apply risk assessment procedures to the extent deemed necessary to confirm the understanding.

The Entity's Fraud Risk Assessment and Monitoring. All entities ought to be proactive in reducing fraud opportunities by identifying and measuring fraud risks, taking steps to mitigate identified risks, and implementing and monitoring appropriate preventive and detective controls and other antifraud measures. However, the nature and extent of these risk assessment and monitoring activities need to be commensurate with the size and complexity of the entity. It is important for management to understand its responsibility for establishing and monitoring the entity's fraud risk assessment process. That process is likely to be less formal and structured in a smaller entity than in a larger entity, but ought to include a sufficient degree of fraud awareness on the part of management or the owner/manager, and appropriate fraud risk management activities, with oversight from those charged with governance. The fraud risk assessment and monitoring process for a typical small to midsize nonpublic company may include:

a. Communicating to employees the owner/manager's views on business practices and ethical behavior, either orally or by example.

b. Thoroughly investigating any incidents of alleged fraud, taking appropriate and consistent actions against violators, assessing how relevant controls could be improved, correcting any effects on the financial statements, and reinforcing the entity's values and expectations through appropriate communication.

c. Considering standards of ethical behavior and appropriate business practices in the entity's employee training and evaluation procedures.

d. Identifying and assessing fraud risks and taking appropriate action to reduce or eliminate the risks.

e. Exercising appropriate oversight of the entity's fraud risk assessment and monitoring activities by means of a board of directors or audit committee.

COSO Principles for Risk Assessment. As discussed later in this lesson, this course provides the principles that represent the fundamental concepts associated with each entity-level component of internal control. Auditors may consider these principles during the process of identifying controls and evaluating their design and implementation. The principles for risk assessment are shown in Exhibit 2-5.

Exhibit 2-5

Risk Assessment—COSO Principles

- The entity specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to financial reporting objectives.
- The entity identifies risks to achieving its objectives and analyzes risks to determine how the risks should be managed.
- The entity considers the potential for fraud in assessing risks to the achievement of financial reporting objectives.
- The entity identifies and assesses changes that could significantly impact the system of internal control.

* * *

Small Business Considerations. Some entities, especially those that are larger or have a higher degree of sophistication, may have a formalized and documented risk assessment process that includes management's approach to enterprise risks, including those that are specifically relevant to financial reporting. However, the process for assessing risk in smaller businesses usually is informal with little or no documentation. The principles of risk assessment may be recognized implicitly rather than explicitly. The owner/manager can learn about risks relating to those principles through direct personal contact with employees and external parties. The owner/manager's in-depth involvement can make risk assessment extremely effective in smaller entities because often the risks are assessed by someone with both access to the appropriate information and a good understanding of its implications.

Risk Assessment Procedures and Factors to Consider. The auditor can tailor risk assessment procedures based on factors such as the size and complexity of the entity. In most situations, it is likely that documented evidence of the entity's risk assessment process will be minimal and the auditor will rely heavily on inquiries of management about how risks are identified and addressed. For most small and midsize nonpublic companies, gaining an understanding of management's risk assessment process will not be a complex process. It will be based on experience with the client, general observations of entity operations, and discussions with management or the owner/manager. Specifically, if the events or circumstances that affect risk (noted previously) have occurred, the auditor might ask management about the associated risks and what actions were taken to address them. Those inquiries may be corroborated by inquiries of accounting and other personnel, as well as by inspecting any other supporting written evidence or by determining if risks occurred that were not identified by management, as illustrated in the following example:

Example 2-1: Evaluating the entity's risk assessment process.

During the audit planning process of Phillips Enterprises, Inc., the auditor learns that a new general ledger system was implemented during the year. When making inquiries about the entity's risk assessment process, the auditor asks the CEO and controller what implementation risks were identified and how they were

addressed. Management indicates that they "spent weeks" planning for the implementation. They identified the following key risks:

- Posting from accounting transaction modules would not properly integrate with the new general ledger system.
- The monthly close and financial reporting processes would be interrupted due to training issues, changes in system performance, and modification in the timing of journal entry processing and edits.

The controller indicates that they addressed these risks by thoroughly testing the system prior to implementation and ensuring that all staff were properly trained and understood the processing changes made by the new system.

Later, as the auditor begins to obtain an understanding of Phillips' financial reporting system, one of the general ledger supervisors complains that the new system does not provide a history of general ledger transactions prior to the implementation date and that some historical information can no longer be obtained since the old system was decommissioned immediately after the implementation. The auditor considers such facts when evaluating the overall effectiveness of the entity's risk assessment process.

Documentation of the Client's Risk Assessment Process. The auditor's understanding of the entity's risk assessment process, along with the sources of information and procedures performed to obtain or update the understanding should be documented. One method for doing so is for the auditor to document the understanding of the client's risk assessment process by considering the principles discussed in Exhibit 2-5 and providing an overall conclusion regarding whether the risk assessment is properly designed and implemented considering the overall size and complexity of the entity.

Information and Communication

Information refers to the financial reporting system, which includes the accounting system, and encompasses the procedures and records established to initiate, authorize, record, process, and report the entity's transactions. It also includes the accountability over assets, liabilities, and equity. An information system may be automated, manual, or a combination of the two depending on the size and complexity of the entity. Communication is the process of providing an understanding of roles and responsibilities to individuals within the organization regarding internal control over financial reporting.

The quality of information generated by the financial reporting system has significant implications for the audit because it affects management's ability to control the entity's activities and prepare reliable financial statements. However, auditors ought not lose sight of the importance of the communication of accounting and financial reporting roles within the entity. Achievement of the objectives of a well-designed financial reporting system can easily fail if accounting personnel do not fully understand their roles and how proper performance mitigates the risks of material misstatement. Although part of the same internal control component, the information and communication processes are discussed separately in the following paragraphs.

Information. In applying the "top-down" approach discussed previously, the entity's information process can be divided into two parts: (a) entity-level considerations that affect the auditor's risk assessment at the financial statement level and the overall audit strategy and (b) activity-level considerations that affect the risk assessment at the account balance, transaction class, and disclosure level. The auditor's consideration of the information process at the entity level focuses on making an overall evaluation of the use and flow of information relevant to reliable financial reporting rather than on obtaining an understanding of specific processes related to account balances, transaction classes, and disclosures. For example, the auditor considers whether the client has entity-level controls in place to effectively support it in identifying, capturing, and using all of the information needed to prepare reliable financial statements, including disclosures. The auditor's understanding is at a high level but sufficiently detailed to identify the significant accounting applications, how information technology is used in those applications, and the relative complexity and importance of use of IT. The auditor also considers the qualifications of accounting personnel and the time pressure they face. Inexperienced or harried accounting personnel make more errors. At the entity level, the auditor evaluates whether the design and implementation of the financial reporting system has

implications for the assessment of risks at the financial statement level (that is, pervasive risks) or the overall audit strategy.

Auditing standards also impose specific requirements related to obtaining an understanding of the financial reporting system at the account balance, transaction class, and disclosure level. That understanding often directly provides information regarding the entity's control activities as well. Obtaining an understanding of the financial reporting system at the account balance, transaction class, and disclosure level, including understanding the financial close and reporting process related to preparation of the financial statements, is discussed later in this lesson. Because the audit is an iterative process, information obtained when evaluating the design and implementation of the financial reporting system at the account balance, transaction class, and disclosure level may confirm or change the auditor's overall conclusion about design and implementation of the information process at the entity level.

Principles for Information. As previously discussed, this course provides principles that represent the fundamental concepts associated with each entity-level component of internal control. Auditors may consider these principles during the process of identifying controls and evaluating their design and implementation. The entity-level COSO principle for the information process is as follows:

> The entity obtains or generates and uses relevant, quality information to support the functioning of internal control over financial reporting.

Risk Assessment Procedures and Factors to Consider. For most small and midsize nonpublic companies, gaining an entity-level understanding of the entity's information process will not be complex. It will be based on experience with the client; general observations of how financial information is identified, captured, and used within the entity; and discussions with management or the owner/manager.

Communication. The auditor needs to obtain a sufficient understanding of how management communicates financial reporting roles and responsibilities and other significant matters. The communication process includes both internal and external elements. For example, it includes communications between management and employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. This will depend on the size and organizational structure of the entity. Auditors consider both:

- The aspects of the communication process that help to ensure employees and those charged with governance understand their jobs and responsibilities within the financial reporting system and are encouraged to report any exceptions.
- Any areas where communication does not occur.

Communication is another way that management conveys the tone at the top. Management ought to communicate the information necessary for employees to perform their assigned tasks, for managers to supervise, and for responsible parties to make key operating and financial decisions. Communication also relates to the flow of information upstream in an entity. For upstream communication to occur, there needs to be open channels of communication and a willingness on the part of management to deal with problems. For control activities to be effective, individuals need to be able to report exceptions or fraud to the appropriate levels of management.

When considering whether an entity has communication controls in place, auditors consider whether management has clearly communicated the following:

- That internal control responsibilities are a critical part of employee job duties.
- The role and responsibilities that each employee has in the internal control system.
- That unexpected events are to be investigated, including determining the cause of the event.
- How job activities relate to the work of others.

- That communication from employees to management concerning exceptions, problems, controls, potential fraud, or other issues is both welcomed and expected. One way management might encourage such communication is to establish a fraud hotline so that employees can report unethical behavior or fraud suspicions without fear of retribution or exposure. In addition to serving as a fraud detection mechanism, the very existence of a fraud hotline can serve as a deterrent to misconduct by creating among employees a perception that fraud will be detected and reported. It also demonstrates management's serious intent to prevent and detect fraud.

- That, if an employee feels that taking an issue through the normal upstream communication methods would not be effective, alternative channels of communication are available (such as a direct communication to senior management).

Small Business Considerations. Communication processes are usually less formal in small businesses but are usually just as effective and efficient. In small businesses with substantial owner/manager involvement, there often is no need for extensive written communication policies or similar documentation. In addition, because of the fewer levels of management, effective communication may be easier to achieve. In a small business, communication will often take place through daily discussions with the owner/manager.

Principles for Communication. As previously discussed, this course provides principles that represent the fundamental concepts associated with each entity-level component of internal control. Auditors may consider these COSO principles during the process of identifying controls and evaluating their design and implementation. Principles for the communication process are shown in Exhibit 2-6.

Exhibit 2-6

Communications—COSO Principles

- The entity internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control over financial reporting.

- The entity communicates with external parties regarding matters affecting the functioning of internal control.

* * *

Risk Assessment Procedures and Factors to Consider. Communication may be written, electronic, oral, or through the direct actions and involvement of management. As a result, auditors often use a combination of risk assessment procedures to understand the communication process. In addition to inquiries of management, the auditor may consider the following types of procedures to corroborate management's responses and determine if the communication process as designed has been implemented:

- Inquire of employees regarding the communication that they have received regarding their duties and management's expectations as they relate to financial reporting.

- Review policy and procedures manuals or similar documents that have been provided to employees regarding their duties.

- Review for the existence of training materials or programs on job functions and responsibilities.

- Discuss with human resources personnel the evaluation process and how job knowledge and the performance of responsibilities are incorporated into personnel reviews.

- Inquire of the audit committee and review minutes of meetings regarding the communication between management and others charged with governance.

- Inquire of employees regarding how upstream financial communication is received and implemented by management.

- Review whistleblower policies and inspect documentation regarding reported instances of suspected financial improprieties.

- Inquire and review related documentation of how communication from external parties is processed.

Gaining an understanding of the client's communication processes need not be a complex process for auditors, especially for small businesses. The auditor does not need to spend much time reviewing client accounting manuals, policies, or memoranda. Ordinarily, the auditor can gain this understanding based on his or her experience with the client, general observations of company operations, and discussions with management or the owner/manager.

Documentation of the Understanding of Information and Communication. The auditor's understanding of the entity-level information and communication processes, along with the sources of information and procedures performed to obtain or update the understanding should be documented. The auditor may want to provide an overall conclusion regarding whether the information and communication process is properly designed and implemented considering the overall size and complexity of the entity. The auditor should also document which controls will be tested. Documentation of the financial reporting system is discussed later in this lesson.

Monitoring

Monitoring is a process by which an entity assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the business. As a result, poor monitoring controls can allow error or fraud to remain undetected. The elements of an entity's monitoring process include (a) ongoing and/or separate evaluations and (b) evaluation and reporting of internal control deficiencies.

Principles for Monitoring. As previously discussed, this course provides principles that represent the fundamental concepts associated with each entity-level component of internal control. Auditors may consider these COSO principles during the process of identifying controls and evaluating their design and implementation. Principles for monitoring are shown in Exhibit 2-7.

Exhibit 2-7

Monitoring—COSO Principles

- The entity selects, develops, and performs ongoing and/or separate evaluations to determine whether the components of internal control are present and functioning.

- The entity evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

* * *

Monitoring Activities. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. For example, management or the owner/manager may question reports that differ significantly from his or her knowledge of operations. Because these activities are performed in the normal course of business, ongoing monitoring procedures usually adapt to changing conditions and may be timely in detecting problems. Separate evaluations may involve any aspect of the entity's system of internal control such as management's review of a component (e.g., the control environment), an element within a component, or the control activities associated with a specific class of transactions or processing function. Regardless of the

manner in which monitoring is accomplished, identified deficiencies ought to be reported to the individuals responsible for taking corrective action and to management and those charged with governance, as appropriate.

According to AU-C 315.23, the auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting, including control activities relevant to the audit. AU-C 315.25 further indicates that the auditor's understanding should include the sources of information related to monitoring and the basis on which management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies.

Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. Monitoring may include activities such as the following:

- Review of whether bank reconciliations are prepared on a timely basis.
- Review of customer complaints regarding the billing process.
- Review of a reporting system that tracks timely collection efforts.
- Analysis of reported disbursement errors.
- Legal department review of compliance with ethics policies.
- Separate evaluation by internal audit regarding revenue recognition.

External parties may provide information to assist the entity in monitoring controls. For example, external auditors may provide recommendations on improving controls as a result of their audit of the financial statements. Customers, by implicitly corroborating billing information through payment of invoices, are another example of external parties that may assist management in their monitoring activities.

Small Business Considerations. Ongoing monitoring activities of a small business are likely to be performed by the owner/manager or other key managers as a by-product of managing the organization. While some small businesses may have internal personnel or external auditors perform separate evaluations of their internal controls, the need for separate evaluations generally is less in a small business due to effective ongoing monitoring activities. Factors to consider in determining whether separate evaluations are needed include the nature of changes occurring within the entity, their associated risks, and the competence and experience of personnel implementing controls, as well as the results of ongoing monitoring. The greater the effectiveness of ongoing monitoring, the lesser the need for separate evaluations.

Risk Assessment Procedures and Factors to Consider. An understanding of an entity's monitoring activities may be obtained through the performance of risk assessment procedures such as direct inquiries of management, review of entity policies and procedures manuals to determine monitoring functions, or procedures performed to obtain an understanding of other components of the entity's internal control system, such as an entity's internal audit function if one exists. For example, when performing a walkthrough of the cash receipts transaction processing system, upon inspection of the monthly bank reconciliation, the auditor notices the reconciliation has been initialed. Upon inquiry of the bookkeeper, the auditor learns that the initials were placed there by the manager to evidence his or her review of the reconciliation process. In this way, the auditor obtains an understanding of both the design of the monitoring controls as well as their implementation.

When making inquiries of management, the inquiries need to be properly adapted for the circumstances. For example, an owner/manager of a small business may exercise extremely effective monitoring controls through daily observation of the performance of personnel, personal conversations with customers and vendors, detailed review of daily bank activity, and similar hands-on activities. Since these activities are performed on an informal basis, the owner/manager may not view them as a "monitoring" process over internal controls, but simply the manner in which business is conducted. Thus, the auditor adapts his or her inquiry to ensure that management understands the nature and objective of the question.

For audits of small and midsize nonpublic companies, the auditor need not spend a great deal of time gaining an understanding of the client's monitoring process. Normally, the auditor can gain this understanding based on his or her experience with the client, general observations of company operations, and discussions with management or the owner/manager.

Consideration of Internal Audit Function. One method some entities use to monitor internal control is through separate evaluations by the internal audit function. Most small and midsize nonpublic companies do not have internal auditors. However, if there is a designated internal audit function, the auditor should obtain an understanding of that function during audit planning. AU-C 315.24 indicates that if the entity has an internal audit function, the auditor should obtain an understanding of the nature of the function's responsibilities, how the function fits into the organizational structure, and the activities performed or to be performed by the function.

In addition, AU-C 240 and AU-C 315 require auditors to inquire of appropriate individuals in the internal audit function about their understanding of the risks of error and fraud within the entity, and AU-C 240.19 goes on to require inquiry about whether the internal audit function has performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from their procedures, and whether they have knowledge of any actual or suspected fraud. The auditor ought to explain that fraud includes both misappropriation of assets and fraudulent financial reporting. The results of those inquiries should be considered when identifying risks of material misstatement due to fraud.

Documentation of the Client's Monitoring Process. The auditor's understanding of the entity's monitoring process, along with the sources of information and procedures performed to obtain or update the understanding should be documented. The auditor can document an overall conclusion regarding whether the monitoring process is properly designed and implemented considering the overall size and complexity of the entity. The auditor should also document which controls will be tested.

IT Environment and General IT Controls

IT Environment. IT systems may include packaged applications provided by vendors; custom developed applications; or end-user computing, such as spreadsheets, that provide accounting data used to generate financial reporting. Many small and midsize businesses have simple IT operations. Typically, they use PCs, which may be linked in a local area network (LAN), and purchased software packages for specific applications, such as accounts receivable. However, some entities may have internal control that is heavily dependent on information technology. Use of the Internet or any other information technology does not necessarily mean that an entity's internal control is heavily dependent on IT.

An entity with a simple IT system may use primarily paper-based manual procedures to enter customer orders, prepare shipping documents and invoices, and maintain accounts receivable. The client may also use manual controls, such as approvals, reconciliations, reviews, and follow-up of exceptions. In a system that uses automated procedures to initiate, record, process, and report transactions, electronic records replace many of the paper forms. Controls in that environment generally consist of a combination of automated and manual controls. Automated controls include processes such as edit and validation routines embedded in software. In addition, the nature of the manual controls may be different. Manual controls in an automated system may be independent of the IT system, may use information produced by the system, or may be limited to monitoring the automated controls and handling exceptions. The mix of manual and automated controls varies with the nature and complexity of the client's system.

The use of manual controls is often more effective when judgment and discretion are needed. For example, manual controls would generally be more appropriate in the following situations:

- Large, unusual, or nonrecurring transactions.
- When monitoring the effectiveness of automated controls.
- In changing circumstances where a control response may be needed outside of the scope of an automated control.
- In circumstances where misstatements are difficult to anticipate, define, or predict.

However, automated controls may be more effective than manual controls in other circumstances. Since manual controls are performed by humans, they may be subject to override, misinterpretation, errors, or bypass. As a result, automated controls may be more suitable in the following circumstances:

- Recurring transactions or high volume.
- Situations where errors can be anticipated or predicted and prevented or detected by control parameters subject to automation.
- Control activities where their nature allows the use of properly designed automated control processes.

The use of IT may enhance the effectiveness and efficiency of the client's internal control because of the consistency, timeliness, and accuracy inherent in automated systems. Use of IT also offers benefits in terms of data analysis, monitoring entity performance, reduced risk of override, and systems and data security. For example, in an IT system, security controls can help achieve segregation of duties. However, the use of IT also poses certain risks to a client's internal control, such as:

- Reliance on systems or programs that are inaccurately processing data or processing inaccurate data.
- Unauthorized access to data that may result in destruction of data or improper changes to data.
- Unauthorized changes to master file data.
- Unauthorized changes to systems or programs.
- Failure to change systems or programs when necessary.
- Inappropriate manual intervention.
- Loss or inability to access data.

The extent and nature of those risks depends on the nature and characteristics of the client's system. In many systems, users can access a common database of information that affects financial reporting. A lack of control at a single user entry point could compromise the security of the database and result in improper changes to or destruction of data. For example, if there are improper controls over the rights and functions of a database administrator, there may be a risk of error or fraud due to unauthorized data manipulation. Similarly, risks may be higher if the client uses an integrated system where various software applications share data. If the applications were provided by different vendors or their integration was not subject to proper controls, the entity may have a higher risk of material misstatements. For example, if a customer order application provided by one vendor uses customer numbers that differ from customer numbers in a customer address and credit limit application provided by another vendor, misstatements can arise unless the data (customer numbers) from each application are properly "mapped" (translated) to each other. This risk of misstatement is reduced if the same vendor provides an application suite and is responsible for the integration of the data shared by the components of the suite.

In many IT environments, the processing of information is decentralized. For example, in a "server-client" arrangement, a central server hosts various clients and processing occurs both centrally on the server and remotely by various clients. As a result, the IT environment is much more open than in the days when all IT processing was confined to a mainframe computer. These environments can present a higher element of risk given a wider range of access to data and processing by a variety of users. The threats to data and financial reporting may range from unauthorized access to data and processing to the introduction of viruses.

In today's IT environments, the processing of financial data often is not confined within formally developed or vendor supplied software applications. In many cases, users may access a database warehouse and import data into a spreadsheet program for processing outside of a "formal" application. Among other things, the output of the spreadsheet application might be used as input for a standard software application, support for journal entries, or support for disclosure information. However, in many cases, unlike the controls over the development or integration of standard software applications, spreadsheet applications developed by users might not be subject to any formalized controls. For example, spreadsheet results may not be subjected to formalized testing or there may be no controls over access, development, modification, or the use of multiple versions of a spreadsheet application.

When obtaining an understanding of the IT environment, auditors consider how procedures are performed using IT and what data is stored. For example, a computer may be used in a discrete accounts receivable system to record customer invoices, prepare sales transaction journals, maintain an accounts receivable trial balance, and process accounts receivable transaction data. Alternatively, computers may be part of an integrated system where significant information is electronically initiated, recorded, processed and reported. In addition, in audits of many smaller businesses, auditors will find that one individual has responsibility for authorizing and originating data, controlling input, editing data, and handling rejected transactions.

As part of the IT environment, the auditor obtains an understanding of the extent to which IT is used for significant transaction classes. Typically, the following matters relating to IT are determined:

- Automated applications and the software that is used.
- Whether software is internally or externally developed, the most current updates or patches have been installed, and whether the client has access to the source code.
- Use of service organizations and whether it is necessary to obtain information about a service organization's controls. That may occur, for example, when a bank provides deposit services, data processing bureau provides payroll services, or broker-dealer provides securities services.
- Significant entity-developed spreadsheets that are used for accounting functions or transaction processing.
- Hardware, networks, and other aspects of the entity's IT system.

General IT Controls. AU-C 315.22 requires the auditor to obtain an understanding of how the entity has responded to IT-related risks. Effective controls to adequately respond to risks that arise from IT include not only properly designed and implemented application controls, but the general controls upon which those application controls depend.

General controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General controls ordinarily include controls related to:

- IT strategic planning and risk management.
- Data center and network operations.
- Physical security and access to programs and data.
- Program changes and systems acquisition and development.

General IT controls relate to all automated applications, including user-developed spreadsheet applications.

The AICPA Risk Assessment Audit Guide (paragraph 4.63) notes that the auditor evaluates the design of IT general controls and determines whether they have been implemented when assessing the risks of material misstatement. Poorly designed general controls do not by themselves cause misstatements in the financial statements. However, deficient general controls may allow application controls to operate improperly which, in turn, can result in material misstatements in the financial statements. Thus, general controls need to be assessed in relation to their effect on applications and data that become part of the financial statements.

In some cases, certain general controls may not be relevant for the period under audit. For example, if the client has an IT environment where application software is obtained from outside vendors with no modification and client personnel do not have access to source code, general controls over the modification of software might not be relevant. Similarly, if no new systems are implemented during the period of the financial statements, weaknesses in the general controls over systems acquisition and development may not be relevant to the financial statements being audited. For smaller entities that use pre-packaged software and do not have access to source code, relevant general controls ordinarily include controls over access to critical hardware, software, and data; controls over upgrades to the entity's operating system and significant pre-packaged applications; systems and data back-up and recovery procedures; and controls over the creation, use, and maintenance of critical spreadsheet applications.

Control Objectives. As discussed earlier in this lesson, when obtaining an understanding of internal control, many auditors consider control objectives during the process of identifying controls and evaluating their design and implementation. Controls are properly designed and implemented if (a) they achieve the control objectives and (b) the entity is using them. Exhibit 2-8 presents a list of control objectives for general IT controls.

Exhibit 2-8

Control Objectives—General IT Controls

- The entity has an IT strategic planning and risk management process in place to support its financial reporting requirements.
- The entity maintains reliable systems that include appropriate data backup and recovery processes.
- Physical security and access to programs and data are appropriately controlled to prevent unauthorized use, disclosure, modification, damage, or loss of data.
- Program changes and systems acquisition and development are appropriately managed to ensure that the application software adequately supports financial reporting objectives.

* * *

Procedures. The auditor's risk assessment procedures to obtain an understanding of general IT controls typically include inquiry of client personnel; inspection of systems documentation, written policies and procedures, incident reports or logs, etc.; and observation of facilities and equipment, the operation of access controls, the performance of backup routines, etc., to understand how general IT control objectives are achieved.

Documenting the IT Environment and General IT Controls. The auditor should document the understanding of the extent to which IT is used in significant transaction classes and whether the use of an IT specialist is considered necessary, as well as the auditor's understanding and conclusion about the design and implementation of general IT controls.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. To obtain an understanding of a client's control environment, the auditor needs an understanding of which of the following (among other things)?

    a. Financial reporting objectives.

    b. The supervisory activities performed by management.

    c. Policy manuals, memos, and other oral and electronic communications.

    d. Human resource policies and procedures.

16. Billy is engaged to audit a midsize nonpublic company. As part of the audit engagement, Billy must obtain an understanding of his client's internal control and how his client deals with risk assessment. Which of the following fraud risk assessment and monitoring processes should Billy's client have?

    a. Allowing auditors, such as Billy, to investigate any possible instances of fraud.

    b. Tasking members of management to provide oversight of the client's fraud risk assessment activities.

    c. Orally communicating management's views on business practices and ethics to employees.

    d. Assuming that new employees have an accurate grasp of appropriate business practices and good ethical behavior.

17. Which of the following is a risk that the use of IT poses to an entity's internal control?

    a. Regular updates to IT systems.

    b. The elimination of manual intervention.

    c. Systems that process data too quickly.

    d. Unauthorized changes to data or programs.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. To obtain an understanding of a client's control environment, the auditor needs an understanding of which of the following (among other things)? **(Page 199)**

    a. Financial reporting objectives. [This answer is incorrect Financial reporting objectives, among other things, are part of the consideration of an entity's risk assessment process, which is a different element of internal control.]

    b. The supervisory activities performed by management. [This answer is incorrect. The monitoring element of internal control includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. Monitoring is a separate consideration from the control environment.]

    c. Policy manuals, memos, and other oral and electronic communications. [This answer is incorrect. As part of the information and communication element of internal control (not the control environment), the auditor needs to obtain a sufficient understanding of how management communicates financial reporting roles and responsibilities and other significant matters. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc.]

    d. Human resource policies and procedures. [This answer is correct. According to AU-C 315.A79, the elements of the control environment that may be relevant when understanding the control environment include (1) participation of those charged with governance, (2) communication and enforcement of integrity and ethical values, (3) management's philosophy and operating style, (4) organizational structure, (5) human resource policies and procedures, (6) assignment of authority and responsibility, and (7) commitment to competence.]

16. Billy is engaged to audit a midsize nonpublic company. As part of the audit engagement, Billy must obtain an understanding of his client's internal control and how his client deals with risk assessment. Which of the following fraud risk assessment and monitoring processes should Billy's client have? **(Page 205)**

    a. Allowing auditors, such as Billy, to investigate any possible instances of fraud. [This answer is incorrect. Billy's client should thoroughly investigate any incidents of alleged fraud, taking appropriate and consistent actions against violators, assessing how relevant controls could be improved, correcting any effects on the financial statements, and reinforcing the entity's values and expectations through appropriate communication. Merely allowing Billy to be the lead on fraud investigation would be an instance of the client having insufficient internal control in this area.]

    b. Tasking members of management to provide oversight of the client's fraud risk assessment activities. [This answer is incorrect. Billy's client should exercise appropriate oversight of the entity's fraud risk assessment and monitoring activities by means of a board of directors or audit committee. Management should not be the only ones performing such oversight for proper internal control.]

    c. Orally communicating management's views on business practices and ethics to employees. [This answer is correct. A small to midsize company, like Billy's client, needs to communicate to employees the owner/manager's views on business practices and ethical behavior, either orally or by example. Therefore, by making this oral communication, Billy's client is properly dealing with an aspect of the risk assessment component of internal control, which Billy can discover while obtaining his understanding of internal control.]

    d. Assuming that new employees have an accurate grasp of appropriate business practices and good ethical behavior. [This answer is incorrect. Small to midsized companies should consider standards of ethical behavior and appropriate business practices in the entity's employee training and evaluation procedures. If they do not, then when Billy obtains his understanding of his client's internal control, he will have to note this deficiency in relation to risk assessment.]

17. Which of the following is a risk that the use of IT poses to an entity's internal control? **(Page 213)**

    a. Regular updates to IT systems. [This answer is incorrect. A risk of using IT is the failure to change systems or programs when necessary. Getting regular updates would help mitigate this risk.]

    b. The elimination of manual intervention. [This answer is incorrect. Inappropriate manual intervention is a risk of using IT systems; however, it is unlikely that the use of IT would eliminate all need for manual intervention.]

    c. Systems that process data too quickly. [This answer is incorrect. A risk of using IT systems is the reliance on systems or programs that are inaccurately processing data or processing inaccurate data. Fast processing speed would most likely be a perk of using IT systems and increase the entity's efficiency.]

    d. Unauthorized changes to data or programs. [This answer is correct. The use of IT can pose certain risks to a client's internal control, including (1) unauthorized access to data that may result in destruction of data or improper changes to data, (2) unauthorized changes to master data, and (3) unauthorized changes to systems or programs.]

ACTIVITY-LEVEL CONTROLS

This course refers to the internal control component of control activities, along with the detailed aspects of the financial reporting system, as "activity-level" controls. Activity-level controls and processes operate at the assertion level rather than at the overall financial statement level. Activity-level controls are directly related to initiating, authorizing, recording, processing, correcting, transferring to the general ledger, and reporting the entity's transactions. Consequently, the understanding of activity-level controls directly supports the auditor's risk assessment at the relevant assertion level for account balances, transaction classes, and disclosures.

As previously discussed, the auditor ordinarily obtains an understanding of entity-level controls first because those controls have a pervasive effect on the entity's financial statements. Also, the auditor generally accumulates a significant amount of knowledge about activity-level controls through the understanding of entity-level controls. Controls throughout the system may be either manual or automated and may be significantly affected by IT. Therefore, the auditor also obtains an understanding of the entity's IT environment and general IT controls when obtaining an understanding of entity-level controls. After obtaining an understanding of entity-level controls, the auditor focuses on obtaining an understanding of the financial reporting system, which is part of the information and communication component of internal control. Obtaining an understanding about how the entity initiates, authorizes, records, processes, and reports transactions through the financial reporting system typically also provides a significant amount of information about control activities. After obtaining an understanding of those aspects of transaction processing, the auditor considers whether it is necessary to devote additional attention to obtaining an understanding of control activities.

This section discusses the understanding of the financial reporting system along with the risk assessment procedures auditors use to obtain that understanding. This section also discusses when it might be necessary to obtain an additional understanding of control activities. Throughout the process of obtaining an understanding of activity-level controls, the auditor remains aware of the requirements to:

- Obtain an understanding of controls related to significant or fraud risks.
- Obtain an understanding of controls related to risks for which substantive procedures alone are not adequate.
- Understand the effects of IT on the entity's control activities.

A more detailed consideration of the control activities that are relevant to the audit is presented in paragraphs –.31.

Financial Reporting System

As previously discussed, the financial reporting system is part of the information and communication component of internal control. The financial reporting system includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, correct, transfer to the general ledger, and report the entity's transactions. It also includes the accountability over assets, liabilities, and equity. Auditors are typically very familiar with the process of understanding the financial reporting system. When obtaining an understanding of the entity's internal control, auditors often spend most of their time in this area because it provides the auditor with other key information needed for the audit. For example, the understanding of the financial reporting system contributes to the auditor's ability to design and conduct efficient and effective substantive procedures because the auditor gains knowledge of the types, sources, and locations of documents and other evidence and the individuals responsible for processing them.

During the process of obtaining an understanding about the financial reporting system, auditors typically gain some knowledge about various monitoring controls or control activities that relate to the processing of transactions and the financial reporting process. In other words, as the auditor learns about how transactions flow through the accounting system and how those transactions are reported in the financial statements, a by-product of that knowledge is an understanding of how management monitors internal control and how certain control activities are applied to achieve accuracy, completeness, cutoff, and other relevant assertions. As a result, many auditors find that it is efficient to gain an understanding of the financial reporting system, internal control monitoring, and control

activities components of internal control at the same time. In fact, as discussed later in this lesson, after the auditor obtains an understanding of the control environment, risk assessment, information and communication (including the financial reporting system), and monitoring, it may not be necessary to devote additional attention to obtaining an understanding of control activities.

AU-C 315.19 states that the auditor should obtain sufficient knowledge of the financial reporting system, including related business processes, as a result of applying risk assessment procedures to understand the following:

- *Classes of Transactions*. The classes of transactions in the entity's operations that are significant to the financial statements.
- *Accounting Procedures*. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
- *Accounting Records*. The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions.
- *Other Events and Conditions*. The methods used to capture events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include asset impairment, commitments and contingencies, concentrations, subsequent events, compliance with debt covenants, related party transactions, going concern uncertainties, and fair values of financial instruments.
- *Financial Reporting Process*. The financial reporting process (including the closing process) used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- *Journal Entries*. The controls over standard and nonstandard journal entries.

A financial reporting system includes methods and records that:

- Identify and record all valid transactions.
- Resolve the incorrect processing of transactions.
- Provide, on a timely basis, sufficient detailed information about transactions to permit proper classification for financial reporting.
- Allow for the recording of transactions at their proper monetary value in the financial statements.
- Provide sufficient information to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

Auditors need to be satisfied that they have a sufficient understanding of the entity's financial reporting system to understand how material misstatements might occur anywhere in the cycle from the occurrence of transactions to the final presentation of the company's financial position and results of operations in the financial statements. Also, as required by AU-C 315.22, when understanding control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. This typically means that when obtaining an understanding of the financial reporting system, the auditor obtains knowledge of relevant IT application controls. Application controls apply to a specific application, such as accounts receivable, payroll, or the general accounting application. They apply to the processing of individual transactions and help ensure that the transactions occurred, are authorized, and are completely and accurately recorded and processed. The AICPA Risk Assessment Audit Guide (Table 3-7) lists examples of general controls and application controls that may be relevant to the audit, including controls relating to the rights of specific users to access the application or data, delete previously processed transactions or data, or originate new transactions or records (such as a new authorized vendor, approved customer, or employee record). Relevant application controls also relate to the integrity, completeness, and

accuracy of data input into and processed by the system, as well as the integrity of resulting reports and information.

In a simple financial reporting system, understanding the financial reporting system will likely involve the following:

a. Understanding the financial close and reporting process.

b. Identifying the entity's significant transaction classes.

c. Understanding the flow of information through the financial reporting system for significant transaction classes.

The following paragraphs provide additional guidance on those steps in understanding the financial reporting system. Guidance is also provided on control objectives for the financial reporting system, risk assessment procedures auditors might use to obtain a sufficient understanding, including walkthroughs, and documentation of the auditor's understanding.

Understanding the Financial Close and Reporting Process. Events and conditions other than transaction classes (that is, other than items processed through the entity's significant transaction processing systems) are often material to the preparation of financial statements. Examples include the fair value of financial instruments, accruals for contingencies, commitments, and related party transactions. Therefore, it is not enough for the auditor to understand the flow of transactions through the financial reporting system for significant transaction classes. The auditor also needs to understand how information about other significant events and conditions is captured. Therefore, for any accounts where material amounts enter the general ledger or financial statements from sources other than the entity's significant transaction processing systems, the auditor needs to understand how information about those events and conditions is captured for inclusion in the general ledger and financial statements. Also, for audit areas requiring significant disclosure information that is not available from the entity's general ledger or related supporting documents and records, the auditor needs an understanding of how information for disclosures is captured for inclusion in the financial statements. For most nonpublic companies, it seems likely that understanding is generally obtained as part of the financial close and reporting process.

The financial close and reporting process is particularly important to achieving reliable financial reporting. Weaknesses in the financial reporting process can create risks of material misstatement. The auditor obtains an understanding of how automated and manual procedures are used to accomplish the following:

- Document and communicate the financial close and reporting process to appropriate departments, individuals, and components.

- Authorize and approve related-party transactions and identify, account for, and disclose related-party relationships and transactions.

- Authorize and approve significant transactions outside the normal course of business.

- Develop and evaluate significant accounting estimates.

- Initiate, authorize, record, and process journal entries.

- Initiate, authorize, and record recurring and nonrecurring adjustments to the financial statements that are not reflected in formal journal entries.

- Perform and review key analyses during the period-end close process.

- Ensure that reporting instructions issued to components are clear and that they (1) adequately describe the accounting policies to be followed, (2) address disclosures needed to comply with GAAP, (3) provide a means of identifying intercompany balances and transactions, and (4) require approval of financial information by component management.

- Combine and consolidate general ledger data.
- Prepare, review, and approve the financial statements and disclosures.

The auditor remains aware that nonstandard journal entries and other topside adjustments made directly to the financial statements have been used in numerous instances of fraudulent financial reporting.

Identifying Significant Transaction Classes. The auditor identifies significant classes of transactions and obtains an understanding of the flow of information (including electronic information) through the entity's financial reporting system for each of those classes. *Significant transaction classes* are those classes of transactions in the entity's operations that are significant to the financial statements, generally because of the volume or risk characteristics of transactions processed. When identifying significant transaction classes, the auditor needs to focus on those that present a reasonable possibility of material misstatement of the financial statements or disclosures, including those that involve significant or fraud risks. Qualitative and quantitative factors such as the following might be considered:

- Volume of activity.
- Size and composition of the related accounts.
- Susceptibility to misstatement due to errors or fraud.
- Nature of the transactions, related account balances, or disclosures.
- Accounting and reporting complexities.
- Exposure to losses in the related accounts.
- Possibility of significant contingent liabilities arising from the activities being processed.
- Existence of related party transactions.
- Changes from the prior period in the characteristics of the transactions, related account balances, or disclosures.

Exhibit 2-9 provides examples of transaction classes for specified audit areas.

For many nonpublic company audits, significant transaction classes will include the following:

- Processing cash receipts.
- Processing disbursements.
- Processing customer orders.
- Shipping and invoicing customer orders.
- Estimating the allowance for doubtful accounts and bad debt expense.
- Recording purchases.
- Receiving and storing inventory.
- Costing inventory.
- Processing accounts payable and accruals.
- Processing payroll.

Exhibit 2-9

Examples of Transaction Classes for Specified Audit Areas

Cash
- Processing cash receipts[a]
- Processing disbursements[a]

Accounts Receivables/Revenues
- Processing customer orders[a]
- Shipping and invoicing customer orders[a]
- Processing revenue adjustments and product returns
- Processing cash receipts[a]
- Estimating the allowance for doubtful accounts and bad debt expense[a]
- Recording deferred revenue
- Estimating the allowance for returns and adjustments
- Maintaining the customer master file

Inventory/Cost of Sales
- Recording purchases[a]
- Receiving and storing inventory[a]
- Requisitioning materials for production
- Costing inventory[a]
- Managing inventory
- Estimating excess and obsolete inventory reserves

Property
- Acquiring and safeguarding property, plant, and equipment
- Depreciating property, plant, and equipment
- Disposing of property, plant, and equipment (sales and retirements)
- Maintaining the property, plant, and equipment sub-ledger
- Assessing assets for impairment

Investments and Derivatives
- Managing investments
- Managing derivatives
- Assessing assets for impairment

Other Assets
- Recording purchases of other assets
- Assessing assets for impairment
- Amortizing assets

Accounts Payable and Other Liabilities
- Recording purchases[a]
- Processing accounts payable and accruals[a]
- Processing disbursements[a]
- Maintaining the supplier master file
- Estimating the warranty reserve and warranty expense

Notes Payable and Long-term Debt
- Managing borrowings

Income Taxes
- Calculating and reporting income taxes

Equity
- Recording equity transactions
- Recording stock compensation

Income/Expense
- Processing payroll[a]
- Maintaining the employee database master file
- Recording repairs and maintenance expense

Note:

[a] For many nonpublic company audits, this will be considered a significant transaction class.

* * *

Understanding the Flow of Information for Significant Transaction Classes. When understanding the flow of information through the entity's financial reporting system for significant transaction classes, the auditor focuses on the entity's procedures for the following aspects of transaction processing:

a. *Initiating and Authorizing.*

(1) How and by whom are transactions initiated and authorized?

(2) What source documents (or electronic means) are used to capture information for entry in the accounting system?

(3) How and by whom are transactions originally entered in the accounting system for processing?

b. *Recording, Processing, and Correcting.*

(1) What are the accounting processing steps, both automated and manual, from original entry to inclusion in the general ledger and who performs them? (Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation.)

(2) What accounting records and supporting documents (manual and electronic) are used or created when processing transactions?

(3) What accounts are involved?

(4) What subsidiary journals or ledgers are involved?

(5) How is the incorrect processing of transactions resolved?

c. *Transferring to the General Ledger, Reconciling, and Reporting.*

(1) What procedures are used to enter transaction totals into the general ledger?

(2) What is the entity's process for reconciling account detail to the general ledger for material accounts?

(3) How does IT affect the entity's control activities?

(4) What management reports or other information are generated from the system and how are they used by management or the owner/manager in managing and controlling the entity's activities?

Throughout the process of obtaining the understanding, the auditor considers the effect of IT on the way the entity's control activities are designed and implemented. The auditor also identifies and evaluates the controls, if any, the entity has implemented to prevent or detect and correct material misstatements related to fraud risks or other significant risks. And the auditor is alert for areas where controls should be tested because substantive procedures alone will not be sufficient to address the assessed risks.

As indicated above, the auditor should obtain an understanding of how the incorrect processing of transactions is resolved. That is a specific requirement of AU-C 315.19. For example, some systems use suspense accounts or files to capture failed transactions. For such situations, the auditor would understand the procedures for suspense accounting including how such transactions are researched and cleared.

In connection with understanding significant classes of transactions, the auditor identifies the related accounts that are material to the financial statements. For material accounts, AU-C 315.21 requires the auditor to understand the process for reconciling detail records to the general ledger. For example, for the accounts receivable general ledger account, the auditor needs to understand the process of reconciling the account to the subsidiary accounts receivable ledger. While reconciling procedures are technically a control activity, the understanding is typically obtained when developing a knowledge of the flow of transactions.

Control Objectives. As previously discussed, when obtaining an understanding of internal control, many auditors consider control objectives during the process of identifying controls and evaluating their design and implementation. Controls are properly designed and implemented if (a) they achieve the control objectives and (b) the entity is using them.

Risk Assessment Procedures. Risk assessment procedures that are ordinarily performed to understand the financial reporting system include inquiries of management and others, observation of entity procedures and controls, inspection of documents and records, and tracing transactions through the system (i.e., walkthroughs). The nature and extent of the procedures performed are affected by factors such as the size of the entity, its complexity, and most certainly, the number of significant transaction classes that exist within the entity.

The existence of any internal documentation that describes classes of transactions and the transaction flow in the accounting system is a key factor that may influence the risk assessment procedures used when obtaining an understanding of the financial reporting system. Typically, such documentation exists for larger and more complex entities and may consist of the following:

- Training manuals for employees.
- Policy and procedure manuals.
- Formal memoranda and flowcharts.
- Internal audit analyses.

When such documentation exists, the auditor's risk assessment procedures typically include inspection and review of this documentation, corroborated by inquiries of various personnel to determine if the information is current, observation, and walkthroughs to verify that procedures are being followed. While the client's internal control documentation is an excellent source for understanding and evaluating the design of the financial reporting system, risk assessment procedures consisting of inquiry, observation, and inspection are necessary to ensure that the system has been implemented as designed.

However, for many small entities, the range of control and day-to-day involvement of management frequently makes written documentation of the processing systems unnecessary. For those entities the auditor often relies on inquiries of management and accounting personnel to understand the design of the financial reporting system. The auditor determines that the system as described has been implemented by performing observation and inspection procedures, such as walkthroughs.

Walkthroughs. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is to trace a transaction through the various processing steps and related controls from initiation to inclusion in the general ledger and the financial statements. This is commonly referred to as a "walkthrough" or "cradle-to-grave" procedure. Walkthroughs may be used to confirm information obtained by inquiry or from prior years' audits. Walkthroughs are also commonly used in gaining an understanding of related control activities. Paragraph 3.123 of the AICPA Risk Assessment Audit Guide and paragraph 3.25 of the AICPA Audit and Accounting Guide, *Audit Sampling*, note that a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of controls.

Walkthroughs of transactions usually involve document inspection, inquiry, and observation. The auditor judgmentally selects one or a few transactions from each of the major classes of transactions and walks those transactions through the system from cradle to grave, that is, from initial creation of a source document to final posting in the general ledger and inclusion in the financial statements. The auditor inspects the documents and accounting records used in processing, talks to the personnel involved, and observes the handling of records and related assets. At each step, the auditor does the following:

- Observes the demonstration of, or reperforms, the prescribed manual and automated processing procedure or control.
- Identifies and examines the documents and IT involved.

- Identifies the name and position of the person who performs the procedure or control and considers the competence and understanding of the person performing the procedure or control.
- Determines whether the procedure is performed as prescribed and on a timely basis.
- Identifies the kinds of errors found by the client and the client's responses to correct them.
- Determines whether the person has been asked to override the procedure or control.
- Identifies exceptions to the prescribed procedure or control.

Some auditors also query individuals about the preceding or succeeding processing step or control activity as a means of obtaining corroborating information about each step in the process.

In performing a walkthrough, the auditor follows the transaction through all of the processing steps in the system. A walkthrough may not be effective if a different transaction is used to test each control separately rather than walking a single transaction through the entire process or if the auditor does not use the same documents and IT that client personnel use. (However, it may be necessary to select additional transactions to verify certain processing steps that may apply for some transactions but not for others. For example, certain of the processing steps and control activities might be different for a customer order originated through an outside sales force versus one originated through a web portal.) Exhibit 2-10 provides examples of how risk assessment procedures might be used in a walkthrough for an accounts payable transaction.

Exhibit 2-10

Examples of Risk Assessment Procedures for a Walkthrough of an Accounts Payable Transaction

Processing Step	Type of Risk Assessment Procedure	Example
Initiation	• Inquiry	• How is the transaction first initiated and by whom?
	• Inspection	• Inspection of the purchase order.
Authorization	• Inquiry	• Who approves purchase orders prior to submission to the vendor and what are the authorization limits?
	• Inspection	• Review of purchase order copy to determine evidence of initialing by the authorizer.
Processing, Correcting, and Recording	• Inquiry	• How are shipments of ordered goods received? • Who receives shipments? • How are submitted purchase orders and goods received, entered, and tracked in the ordering systems? • How are accounts payable invoices matched to purchase orders and receiving records? Who performs this process? • How is the accuracy of invoices determined? • How are exceptions identified? • How are identified errors corrected? • How are invoices entered into the payable system?

Processing Step	Type of Risk Assessment Procedure	Example
	• Inspection	• Review of entry into the purchase order system. • Review of receiving records for the transaction. • Review of the evidence that denotes performance of the matching process. • Review of the accounts payable invoice for evidence of clerical processing. • Tracing the recording of the transaction into the accounts payable and or purchase order system.
	• Reperformance	• Reperforming the matching between the purchase order, receiving record, and accounts payable invoice. • Reperforming any mathematical or other accuracy testing of the accounts payable invoices.
	• Observation	• Visiting receiving departments noting how shipments are received and checked. • Verifying segregation of duties by observing the roles of individuals that perform the functions.
Transferring to the General Ledger, Reconciling, and Reporting	• Inquiry	• How are accounts payable transactions entered into the general ledger? • How is the accounts payable detail record reconciled to the general ledger? • How are processing errors caught and corrected?
	• Inspection	• Tracing the recorded transaction into the general ledger. • Reviewing the reconciliation of the accounts payable general ledger account to the detail for the month of entry.
	• Reperformance	• Reperforming certain steps of the reconciliation process including how exceptions were recognized and corrected in ensuing months.

* * *

How Often to Perform Walkthroughs. A nonauthoitative AICPA Technical Question and Answer, *Use of Walkthroughs* (Q&A 8200.12) discusses performing walkthroughs. As noted above, the use of walkthroughs is a common practice for obtaining an understanding of the design and implementation of the financial reporting system. The Q&A notes that auditors may perform walkthroughs every year for significant accounting cycles. Even

though, as explained in Lesson 1, AU-C 315 allows the auditor to rely on audit evidence obtained in prior periods in certain situations, the auditor is still required to determine the continued relevance of that evidence. In many cases, the auditor can establish this relevance through the performance of a walkthrough. Indeed, the AICPA Risk Assessment Audit Guide (paragraph 3.140) notes that a walkthrough may be helpful in determining whether and how internal control design and implementation have changed since the prior period. Thus, walkthroughs are ordinarily performed in each audit period for significant transaction classes.

However, the AICPA Risk Assessment Audit Guide (paragraph 3.140) also states that the auditor may determine that a walkthrough is not necessary in determining whether and how controls have changed. Instead, it is important that the auditor first understand the audit objective (establish the continued relevance of prior periods' audit evidence) and then identify the audit procedure(s) that can meet that objective. Paragraph 3.141 of the AICPA Risk Assessment Audit Guide summarizes the following factors that may be considered in determining the nature, timing, and extent of procedures for updating the understanding of internal control gained in the prior year:

- Effectiveness of the client's control environment, management's risk assessment, monitoring, and general controls.
- Reliance on automation.
- Changes in client circumstances, such as personnel, business practices, expanded operations into other locations, etc.
- Risks of material misstatement for the relevant assertion.
- Length of time since performing extensive risk assessment procedures (initial evaluation of internal control design and implementation).

Using prior year evidence is more appropriate when controls are more effective and automated (assuming effective general controls), changes in client circumstances are fewer, risks of material misstatement are lower, and the length of time since the initial control evaluation is shorter.

The AICPA Risk Assessment Audit Guide (paragraph 3.137) notes that decisions about the nature, timing, and extent of the procedures for updating the understanding of the client are made on an process-by-process basis and not globally for the entire audit. For example, assume that in previous audits walkthroughs were performed for all significant classes of transactions. In the current period, client conditions may cause the auditor to determine that making inquiries of selected client personnel may be sufficient for accounts receivable but that a walkthrough and other procedures are necessary for inventory.

Control Activities

Control activities are the policies and procedures that help ensure that management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting. Control activities usually involve two elements: (a) a policy that establishes what ought to be done and (b) the procedure that implements the policy. AU-C 315.21 requires the auditor to obtain an understanding of control activities relevant to the audit and explains that they are those which "the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to the assessed risks."

AU-C 315.A157 provides examples of categories of control activities that are relevant to the audit are as follows:

- *Performance Reviews.* Comparisons of current financial reports to other information.
- *Information Processing.* Control activities that are performed to check the accuracy, completeness, and authorization of transactions. For information processing systems, there are two broad categories of control activities—application controls and general controls. General controls were discussed earlier in this lesson.

- *Physical Controls.* Controls that pertain to the physical security of assets, including adequate safeguards that limit access to assets, authorization safeguards for access to software, including coding and files, and periodic counting and comparison of assets to control records.

- *Segregation of Duties.* The assignment of different people to authorize transactions, record transactions, and maintain custody of assets.

- *Accountability.* Controls relating to reconciliations of the detailed records to the general ledger.

AICPA Nonauthoritative Guidance on Control Activities Relevant to the Audit. The AICPA has issued Technical Questions and Answers that provide nonauthoritative guidance on those control activities that are always relevant to the audit and those that may be relevant to the audit based on auditors' evaluation of all the particular facts and circumstances of the engagement.

Control Activities Always Relevant to the Audit. The AICPA Technical Question and Answer, *Control Activities Always Relevant to the Audit* (Q&A 8200.20), indicates that certain control activities, if present, are always relevant to the audit. It states that these control activities are those that address the following matters:

- Significant risks.

- Fraud risks.

- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

- Risks for which there is an intention to rely on operating effectiveness of controls to determine the nature, timing, and extent of substantive procedures.

- Recording of journal entries including nonstandard entries that record adjustments or nonrecurring, unusual transactions.

- Responses by the entity to risks arising from IT that may affect the design or implementation of control activities.

- Use of service organizations that fall into any of the above categories.

Control Activities That May Be Relevant to the Audit. AICPA Technical Question and Answer, *Control Activities That May Be Relevant to the Audit* (Q&A 8200.21), observes that auditors need not obtain an understanding of all control activities related to each significant class of transactions, account balance, or disclosure in financial statements or to every assertion that is relevant to them. It notes that the following factors may be helpful in identifying whether control activities other than those listed in the previous paragraph are relevant to the audit:

- Analysis of risks of material misstatement to identify control activities related to higher risks of material misstatement.

- Consideration of whether the understanding of other components of internal control indicates a need for additional attention to particular control activities.

- Analysis of deficiencies related to general IT controls or implementation of new systems to identify the effect on the effectiveness of the design or operation of application controls.

- Identification of lack of segregation of duties that limits the importance of control activities and may increase that of other controls such as management review controls.

- Identification of legal or regulatory requirements that increase the importance of particular control activities.

- Decisions to use information produced by the entity in designing and performing further procedures that increase the importance of controls over the completeness and accuracy of that information.

- Determination that control activities related to nonfinancial reporting objectives of internal control, such as operations or compliance, are relevant to the reliability of financial reporting.

- Determination that control activities that are always relevant to the audit are dependent on other control activities.

COSO Control Activities Principles. As previously discussed, the COSO framework provides 17 principles that are associated with the five components of internal control. The principles aid in understanding the requirements for effective internal control and provide clarity for entities when designing and implementing systems of internal control. The principles associated with the control activities component are shown in Exhibit 2-11.

Exhibit 2-11

Control Activities—COSO Principles

- The entity selects and develops control activities that contribute to the mitigation of risks to the achievement of financial reporting objectives to acceptable levels.

- The entity selects and develops general control activities over technology to support the achievement of financial reporting objectives.

- The entity deploys control activities through policies that establish what is expected and procedures that put policies into action.

* * *

This course does not include a detailed discussion of the COSO framework. General IT controls were discussed earlier in this lesson, and that discussion provides detailed control objectives. Control objectives relating to transaction classes by audit area were also discussed earlier in this lesson.

Small Business Considerations. Control activities relevant to the audit of a smaller nonpublic company, according to AU-C 315.A97 are likely to relate to the main transaction cycles, such as revenues and expenditures, including payroll. AU-C 315.A96 explains that for smaller nonpublic companies, control activities are likely to be similar to those for larger entities, but the formality of their operation may differ. Also, it explains that certain control activities may not be relevant because of controls applied by management. For example, segregation of duties often presents difficulties due to the limited number of employees. However, even small businesses with few employees may be able to assign responsibilities to achieve adequate segregation. If this is not possible, direct oversight by the owner/manager can usually provide the necessary control. For example, in the area of cash, the owner/manager might compensate for a lack of segregation of duties by being the only authorized check signer, by receiving bank statements directly, and by reviewing all bank statements and reconciliations.

Obtaining an Understanding of Control Activities. As indicated previously, the auditor first considers knowledge about control activities obtained through the understanding of other components of internal control, including the financial reporting system, before investing additional efforts. Generally, the auditor accumulates a significant amount of knowledge about control activities through the process of obtaining an understanding of the other components. Exhibit 2-12 illustrates situations where an auditor might learn of control activities when obtaining an understanding of other components.

Exhibit 2-12

Examples of Control Activities Identified through Other Components

Control Component	Example of Control Activity Identified
Control Environment	• When obtaining an understanding of management's overall commitment regarding internal controls, the auditor learns of control activities relating to significant estimates which the auditor had identified as a risk area. • When obtaining an understanding of the control environment, the auditor learns about the assignment of authority and responsibility, including whether there is a basic segregation of duties related to assets subject to misappropriation, such as cash, and whether there are effective reconciliation procedures that systematically compare assets with the accounting records.
Risk Assessment Process	• Management has identified and assessed inventory theft risks associated with a new product line with a high cost per unit that was introduced during the year. Management describes the control activities that were developed to safeguard inventory in response to this risk.
Monitoring	• When responding to monitoring queries, management describes how the controller reviews sensitive valuation procedures relating to the impairment of long-lived assets and goodwill.
Information and Communication (including the Financial Reporting System)	• When performing the walkthrough of the billing process, the auditor learns of a review activity by the revenue accounting manager to ensure that components of complex contract billings are properly recognized or deferred based on relevant accounting standards. • When obtaining an understanding of the accounting processing and records for cash, the auditor learns about the client's process for reconciling bank accounts.

* * *

The auditor may also learn of control activities while performing risk assessment procedures to obtain the understanding of the entity and its environment discussed in Lesson 1. Most frequently, however, the auditor learns of control activities while obtaining an understanding of the financial reporting system as discussed earlier in this lesson. A natural by-product of the understanding of how transactions are initiated, authorized, processed, corrected, transferred to the general ledger, and recorded is knowledge of how control activities ensure that relevant assertions are achieved.

When Is an Additional Understanding of Control Activities Necessary? Auditing standards do not require an understanding of all of the control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every assertion. The auditor's emphasis is on understanding control activities that allow the auditor to assess risks of *material* misstatement at the *relevant* assertion level and to design and perform further audit procedures that are responsive to those risks. Thus, after considering the control activities previously identified, the auditor evaluates whether a sufficient understanding of control activities has been obtained for those areas where the auditor considers material misstatements more likely to occur. The auditor's evaluation will be focused on significant transaction classes and accounts. The auditor may need to devote additional attention to

obtaining an understanding of control activities in certain circumstances. For example, it is necessary to obtain an additional understanding if—

- The auditor does not understand what controls, if any, the entity has implemented to prevent, or detect and correct, material misstatements in specific assertions related to fraud risks or other significant risks. Controls related to fraud risks and other significant risks were discussed earlier in this lesson.

- The auditor plans or is required to test controls for one or more assertions but has not identified which controls to test (that is, which manual or automated controls are most likely to prevent, or detect and correct, material misstatements in that assertion).

Thus, even if the auditor concludes additional attention to control activities is necessary, the auditor can focus on controls related to specific transactions, account balances, or assertions. The practical implication of this selective approach is that it is not necessary to complete an internal control questionnaire or prepare additional documentation to describe the control activities for all material account balances and transaction classes. The auditor may identify key balances, classes, or assertions and conclude that a further understanding of control activities is necessary only for those selected areas (such as, completeness of cash revenues for a retailer or nonprofit organization).

In determining the knowledge of control activities necessary to identify types of potential misstatements and develop appropriate responses, the auditor considers experience with the client in prior audits and the knowledge and understanding of the client's business and industry, including the discussion among the engagement team about the risks of fraud and the information gathered to identify fraud risks. The auditor also considers the complexity and sophistication of the client's operations and financial reporting system. In small business audits, for example, the knowledge of control activities gained when obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components of internal control ordinarily is sufficient. That is, a simple operation with simple, routine accounting processing would generally require no knowledge of control activities beyond that gained from understanding the control environment, risk assessment, information and communication (including the financial reporting system), and monitoring components of internal control. When considering control activities, auditors might find the discussion on "A Practical Approach for Obtaining an Understanding of Internal Control" from earlier in this lesson helpful.

In certain circumstances the auditor's understanding of control activities may need to be more extensive than the knowledge gained when obtaining an understanding of the other four components of internal control. If the complexity or sophistication of the entity's operations limit the auditor's knowledge of potential material misstatements, a further understanding of control activities is necessary. For example, accounting for complex activities, such as a hedge fund that engages in a wide variety of equity and derivative securities transactions; an accounting system that relies on another entity to maintain detailed transaction records; or an accounting system with a high volume of low dollar transactions that are not recorded individually may require the auditor to obtain additional knowledge about control activities to identify the types of misstatements that could occur and design substantive procedures effective in detecting such misstatements or design tests of controls. A further understanding of control activities also may be necessary when the client depends heavily on IT to initiate transactions or accounting entries, or to process and control substantially all of the information with little or no user involvement, in one or more significant applications. In such a situation (as in an e-business environment), a further understanding of general, application, and user controls is generally necessary. If the auditor has an adequate knowledge of the potential causes of material misstatements, it may be possible to design effective audit tests without a further understanding of control activities. The key is always what is necessary to design effective audit tests in the circumstances to adequately respond to the auditor's risk assessment. The case study below discusses considerations when the auditor decides to obtain a further understanding of control activities.

If the auditor considers it necessary to obtain an additional understanding of control activities due to the conditions listed above, or for other reasons decides he or she does not have a sufficient understanding to assess the risks of material misstatement and develop appropriate responses, the auditor applies additional risk assessment procedures to understand the relevant control activities and evaluate their design and implementation. When determining risk assessment procedures that may be used to identify control activities, consider the earlier discussion related to the financial reporting system. In addition, the auditor may consider applying walkthrough procedures to confirm the understanding as discussed earlier in this lesson.

Some auditors use an internal control questionnaire as a memory jogger when initially gaining an understanding of control activities or when obtaining a further understanding. Such questionnaires provide common manual and automated control activities for typical accounts or transaction classes that are found in most entities.

Case Study on Extent of Understanding of Control Activities. AEC, Inc., is a construction contractor and uses the percentage-of-completion accounting method for recognizing revenues and the related costs. Revenue earned and the cost of revenue earned are determined by multiplying the most current estimates of total contract prices and costs by an engineering estimate of percentage of completion. The percentage of completion is determined by software that combines estimates with the company's experience on similar contracts over the past year. The electronically-determined percentage of completion becomes the input to another program that calculates revenue earned, cost of revenue earned, and gross profit by contract from inception to date and for the current period. Does the auditor need to obtain an understanding of the control activities over the process resulting in contract gross profit or can the auditor take a substantive approach in this engagement?

In this case, an understanding of the control activities and related processing for determination of percentage of completion would seem to be essential. The auditor could take a substantive approach to total contract revenues and costs, but the determination of percentage of completion is a critical factor. The auditor needs to obtain a sufficient understanding of the process by which the percentage is determined and the controls over that process to know the possible errors or fraud that may be introduced. AU-C 240 requires auditors, when identifying and assessing risks of material misstatement due to fraud, to presume that risk of fraud exists in revenue recognition. Normally, this presumption seems difficult, if not impossible, to rebut when an entity recognizes revenue using the percentage-of-completion method. Accordingly, the auditor could not design effective substantive procedures without a reasonably detailed knowledge of the process for calculation of percentage of completion and the control activities related to that process. Depending on the auditor's conclusion about whether substantive procedures alone are sufficient to provide reasonable assurance of detecting material misstatements, tests of controls might be necessary.

Documenting Activity-level Controls

It is a best practice for auditors to document activity-level controls. One method for doing so is to use practice aids, such as those provided in *PPC's Guide to Audits of Nonpublic Companies.*

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Which of the following statements best describes an aspect of the auditor's understanding of the financial system during an audit engagement?

    a. The financial reporting system is part of the control activities element of internal control.

    b. Risk assessment procedures are performed for entity-level controls but not activity-level controls such as the financial reporting system.

    c. A basic understanding of the financial reporting system includes understanding significant transaction classes and the flow of information.

    d. The auditor's understanding of the financial reporting system will be self-contained.

19. Observation can help an auditor understand which processing step in an entity's financial reporting system?

    a. Initiation.

    b. Authorization.

    c. Processing, correcting, and recording.

    d. Transferring to the general ledger, reconciling, and reporting.

20. Control activities that address which of the following would always be considered relevant to an audit engagement?

    a. Risks for which appropriate evidence cannot be obtained with substantive procedures alone.

    b. Deficiencies related to general IT controls and the implementation of new systems.

    c. A lack of segregation of duties on the part of the audit client.

    d. All control activities related to significant transaction classes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Which of the following statements best describes an aspect of the auditor's understanding of the financial system during an audit engagement? **(Page 222)**

    a. The financial reporting system is part of the control activities element of internal control. [This answer is incorrect. The financial reporting system is part of the information and communication component of internal control. The financial reporting system and control activities elements are both related to activity-level controls.]

    b. Risk assessment procedures are performed for entity-level controls but not activity-level controls such as the financial reporting system. [This answer is incorrect. AU-C 315.19 states that the auditor should obtain sufficient knowledge of the financial reporting system, including related business processes, as a result of applying risk assessment procedures to understand items including classes of transactions, accounting procedures, and accounting records.]

    c. A basic understanding of the financial reporting system includes understanding significant transaction classes and the flow of information. [This answer is correct. In a simple financial reporting system, understanding the financial reporting system will likely involve (1) understanding the financial close and reporting process, (2) identifying the entity's significant transaction classes, and (3) understanding the flow of information through the financial reporting system for significant transaction classes.]

    d. The auditor's understanding of the financial reporting system will be self-contained. [This answer is incorrect. During the process of obtaining an understanding about the financial reporting system, auditors typically gain some knowledge about various monitoring controls or control activities that relate to the processing of transactions and the financial reporting process. Therefore, the understanding of the financial reporting system is not self-contained to that part of internal control but can encompass other elements.]

19. Observation can help an auditor understand which processing step in an entity's financial reporting system? **(Page 227)**

    a. Initiation. [This answer is incorrect. Appropriate risk assessment procedures for testing the initiation of transactions in accounts payable include inquiry and inspection, but not observation.]

    b. Authorization. [This answer is incorrect. Inquiry and inspection, not observation, are appropriate risk assessment procedures for testing how an entity authorizes accounts payable.]

    c. Processing, correcting, and recording. [This answer is correct. There are more appropriate risk assessment procedures for testing how an entity processes, corrects, and records transactions in accounts payable than for any other processing step. Appropriate risk assessment procedures include inquiry, inspection, reperformance, and observation. As part of observation, the auditor might visit receiving departments and note how shipments are received and checked or verify segregation of duties by observing the roles of individuals that perform the functions.]

    d. Transferring to the general ledger, reconciling, and reporting. [This answer is incorrect. When testing an entity's procedures for making transfers to the general ledger, reconciling, and reporting accounts payable transactions, appropriate risk assessment procedures include inquiry, inspection, and reperformance, but not observation.]

20. Control activities that address which of the following would always be considered relevant to an audit engagement? **(Page 230)**

    a. Risks for which appropriate evidence cannot be obtained with substantive procedures alone. [This answer is correct. The AICPA Technical Question and Answer, *Control Activities Always Relevant to the Audit* (Q&A 8200.20), indicates that certain control activities, if present, are always relevant to the audit. It states that these control activities are those that address matters such as significant risks, fraud risks, and risks for which substantive procedures alone do not provide sufficient appropriate evidence.]

    b. Deficiencies related to general IT controls and the implementation of new systems. [This answer is incorrect. According to AICPA Technical Question and Answer, *Control Activities That May Be Relevant to the Audit* (Q&A 8200.21), some factors may be helpful in identifying whether certain control activities are relevant to an audit engagement. However, the factors listed in this guidance may not *always* be relevant to the audit. One control activity listed in Q&A 8200.21 is analysis of deficiencies related to general IT controls or implementation of new systems to identify the effect on the effectiveness of the design or operation of application controls.]

    c. A lack of segregation of duties on the part of the audit client. [This answer is incorrect. According to Q&A 8200.21, there are control activities that may be relevant to an audit, but they are different from the list of control activities *always* relevant to the audit provided by Q&A 8200.20. One of the activities listed in Q&A 8200.21 is identification of lack of segregation of duties that limits the importance of control activities and may increase that of other controls such as management review controls.]

    d. All control activities related to significant transaction classes. [This answer is incorrect. Q&A 8200.21 observes that auditors need not obtain an understanding of *all* control activities related to each significant class of transactions, account balance, or disclosure in financial statements or to every assertion that is relevant to them. Therefore, gaining an understanding of all such controls would be overauditing.]

Lesson 3: Planning Decisions and Judgments, Fraud, Laws and Regulations, and the Audit Time Estimate

INTRODUCTION

This lesson discusses several remaining elements of risk assessment and planning that can affect continuing audits of nonpublic companies.

It begins with a discussion of the planning decisions and judgments that an auditor may need to make during this type of engagement, such as determining materiality, determining performance materiality, and establishing an overall audit strategy.

Next, Lesson 3 takes a look at considerations auditors will need to make related to fraud and relevant laws and regulations. Of particular concern are misstatements caused by fraud and the auditor's responsibilities for laws and regulations both when planning and performing the audit engagement.

Finally, this lesson concludes by discussing how to plan an audit time estimate for the engagement, which can be used to improve the efficiency of the engagement.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the planning decisions and judgments that an auditor must make when auditing a nonpublic company.
- Determine the auditor's responsibilities related to fraud, laws, and regulations when auditing a nonpublic company and recognize how to plan an appropriate audit time estimate.

MAKING PLANNING DECISIONS AND JUDGMENTS

The information the auditor obtains about the entity and its environment by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments based on this information are as follows:

a. The materiality level for the financial statements taken as a whole (preliminary planning materiality).

b. Materiality for particular items of lesser amounts than planning materiality.

c. The risks of material misstatement at the financial statement level.

d. The overall audit strategy (a collective group of judgments about the audit approach, including overall responses to risks).

e. Performance materiality at the individual class of transactions, account balance, or disclosure level.

f. Risks of material misstatement at the relevant assertion level related to classes of transactions, account balances, and disclosures.

g. The specific nature, timing, and extent of further audit procedures.

The audit planning process is iterative and continuous. Some risk assessment procedures are performed to consider audit risk and materiality at the financial statement level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures.

Discussion of the risks of material misstatement at the relevant assertion level for account balances, transaction classes, and disclosures and the specific nature, timing and extent of further audit procedures are beyond the scope of this course. More information on these topics can be found in *PPC's Guide to Audits of Nonpublic Companies*. The other planning decisions and judgments (items a.–e. above) are discussed in the following paragraphs.

Determining Materiality at the Financial Statement Level

According to AU-C 320.10, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements. The auditor uses the concept of materiality both in (a) planning and performing the audit and (b) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. These two perspectives of the concept are usually referred to in practice as (a) *planning materiality* and (b) *evaluation materiality*.

Understanding the similarities and differences between planning materiality and evaluation materiality provides helpful background for making materiality decisions and judgments. AU-C 320.06 explains that planning materiality is not necessarily the amount below which uncorrected misstatements, individually or in the aggregate, will be evaluated as immaterial. Because of surrounding circumstances, the auditor may evaluate an amount as material even if it is below planning materiality. AU-C 320.06 observes that it is not practical to design audit procedures to detect misstatements that could be material solely because of their nature (qualitative considerations), but when evaluating the effect of uncorrected misstatements on the financial statements, the auditor considers not only the size but also the nature of uncorrected misstatements and the particular circumstances of their occurrence. The implication of these matters explained in AU-C 320 is that determination of planning materiality is primarily a quantitative consideration, even though qualitative considerations influence evaluation decisions and judgments significantly.

Establishing Planning Materiality. The auditor's determination of materiality, according to AU-C 320.04, is a matter of professional judgement and is affected by the auditor's perception of the financial information needs of users of the financial statements. AU-C 200.07 observes that generally misstatements or omissions are viewed as material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions made by users that are based on the financial statements, and that materiality decisions involve both quantitative and qualitative considerations. AU-C 320 does not adopt or provide a specific definition of materiality. AU-C 320.02 refers the auditor to the discussion of materiality in the financial reporting framework applicable to the preparation and fair presentation of the financial statements under audit.

If the financial reporting framework is GAAP, for example, then the pronouncements of the FASB would provide a frame of reference for making materiality decisions and judgments. For GAAP, the conceptual touchstone for determining materiality is the following definition from the nonauthoritative FASB Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting—Chapter 3, "Qualitative Characteristics of Useful Financial Information"*:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report.

The reference to "based on the nature or magnitude or both" in that definition recognizes that qualitative as well as quantitative factors influence materiality judgments. As previously mentioned, however, in determining *planning* materiality the focus is generally on quantitative factors. For this reason, auditors have historically used some common rules of thumb in establishing planning materiality.

Overall Approach to Establishing Planning Materiality. These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. AU-C 320.A5 acknowledges the appropriateness of using this

approach as a starting point in determining materiality for the financial statements as a whole and suggests the following factors that may affect the identification of an appropriate benchmark:

- Elements of the financial statements (assets, liabilities, equity, revenue, expenses).
- Focus of financial statement users' attention on particular items (for evaluating financial performance, for example, profit, revenue, or net assets).
- Nature of the entity, where it is in its life cycle, and the industry and economic environment in which it operates.
- Ownership structure of the entity and the way it is financed (for an entity financed solely by debt, for example, users may put more emphasis on assets and claims on assets than on earnings).
- Relative volatility of the benchmark.

AU-C 320.A6 provides the following examples of benchmarks that might be appropriate depending on the nature and circumstances of the entity:

- Total revenue.
- Gross profit.
- Profit from continuing operations before tax.
- Profit before tax.
- Total expenses.
- Total equity.
- Net asset value.

The appropriateness of a benchmark and the related appropriate percentage vary with the circumstances. In addition to assessing what the users of the financial statements are likely to regard as important, the following factors underlying the circumstances of a particular benchmark may be necessary to consider:

- Significant changes in the economy or industry in the current period.
- Significant revisions in the entity's budgets or forecasts.
- Significant changes in financial position or operating results between the prior period and period to date.
- Significant changes in the entity's conditions.

If the auditor selects total revenue as the appropriate benchmark, for example, the cause of an increase in revenue may influence whether to use the current period amount or normalized revenue for a few prior periods. An unusual or nonrecurring increase may point toward using a normalized amount.

Desirability of a Single Benchmark. One reason for the desirability of a single benchmark arises from the practical requirements of audit planning. To understand the use of materiality in planning, it is helpful to contrast planning with evaluation. When the auditor is evaluating the materiality of misstatements at the conclusion of the audit, different materiality levels may be used for different financial statements. In planning, the auditor does not know in advance whether the misstatements that will be detected by a particular audit procedure will affect the balance sheet only, the income statement only, or both statements. Thus, using several levels of materiality is impractical in planning. Also, when planning audit procedures, the auditor often needs to use a specific dollar amount in selecting items to test. For example, the auditor needs to use a specific amount in making decisions about the

scope of a test, such as examining all cash disbursements in the subsequent period or all additions to property above a specific dollar amount. A range is not useful for making scope decisions but may be helpful in evaluation; for example, deciding that in particular circumstances an error over $10,000 is material, an error under $5,000 is immaterial, and an error between $5,000 and $10,000 may be material. That type of guide can be useful in evaluation, but it does not work well in planning. The auditor decides whether an audit test needs to be extensive enough to detect misstatements over $5,000 or over $10,000. A range is not useful for this purpose. In another example, when using a formula to determine sample size for a test of details, the auditor needs to use a specific dollar amount of tolerable misstatement. The single benchmark used should be based on the auditor's best judgment about the relative importance users attach to the benchmark, and the auditor should select the one most important to users. Auditors typically do not use an average of several benchmarks because a simple average would dilute the effect of the most important benchmark, and weighting benchmarks is overly complicated and not supported by common practice.

Selecting a Benchmark. Selecting a benchmark may be considered the most important aspect of determining planning materiality because, as explained in AU-C 320.A9, there is a relationship between the percentage and the chosen benchmark. In practice, a particular range of percentages is commonly associated with a particular benchmark.

AU-C 320 indicates that the auditor's judgment about the determination of materiality is affected by the auditor's perception of the financial information needs of users. For this reason, some auditors begin the process of selecting a benchmark by specifically identifying known users, or categories of users, of the nonpublic company's financial statements, based on discussions with management and those charged with governance and the auditor's experience with the entity in prior periods. These auditors then consider which of the several possible benchmarks would influence the decision making of the users. This approach does not change the fact that the financial statements are general-purpose financial statements and not intended solely for a particular user or purpose. Identifying users helps the auditor focus on the needs of users in selecting an appropriate benchmark.

Other factors that may affect the auditor's selection of the appropriate benchmark, as identified in AU-C 320.A5 and listed above, are the nature of the entity, where it is in its lifecycle, and the industry and economic environment in which it operates. For a nonpublic company for which financial statement users are focused on growth, revenue may be the appropriate benchmark. If the focus is on the ability to control costs of goods sold and operating expenses, the total expenses might be more appropriate. For a company where the focus is on ability to acquire adequate funding of capital, equity might be a more appropriate benchmark.

Some auditors believe that in selecting an appropriate benchmark, a useful approach is to calculate what planning materiality would be using several different benchmarks, such as total assets, total revenue, income before taxes, and equity, to compare the results, and then to evaluate whether the chosen benchmark seems reasonable in relation to the other benchmarks. Some auditors compare the results of these calculations and judgmentally determine a planning materiality amount after taking them all into consideration but not mechanically averaging the results.

Some auditors favor benchmarks that are not volatile and that are, thus, more stable and predictable. As noted above, AU-C 320.A5 acknowledges that the relative volatility of the benchmark is a factor to consider in identification of an appropriate benchmark. For many nonpublic companies, total assets or revenue often provides a sound benchmark. Using either total assets or total revenue as a benchmark has the advantages of relative stability, predictability, and representativeness of entity size. Nevertheless, because it is unlikely that such benchmarks will adequately address user needs for all entities and circumstances, the auditor needs to identify whether there are financial statement items on which, for the particular entity, users' attention tends to be focused. If a financial statement item is clearly more important to users than total revenue or total assets, then the auditor ought to determine the planning materiality amount using that financial statement element as the benchmark. For example, if users of the financial statements are particularly concerned with income, a profit-related benchmark may be more appropriate, but not if there have been unusual decreases or increases in profit, that is, volatile earnings. For some companies, pretax income may fluctuate too much to be a useful benchmark for planning audit testing. It would not be reasonable for the extent of tests to double simply because pretax income is cut in half in a particularly difficult year. Nor would it be reasonable to expect negligible allowable misstatement simply because a company is

operating near the break-even point. Also, if past experience indicates a reasonable expectation of significant audit adjustments, a preliminary amount based on pretax income would not be useful.

Regardless of the benchmark the auditor selects for planning the extent of audit testing, he or she needs to be satisfied that the resulting planning materiality provides an appropriate amount for determining the nature, timing, and extent of planned procedures that will be adequate to provide reasonable assurance that the financial statements are free from material misstatement, even if a different materiality amount is used for evaluation of audit differences. A planning materiality amount is used primarily to plan the extent of audit testing, but does not necessarily provide a basis for determining the adequacy of other aspects of audit planning, namely, the nature and timing of procedures. Also, as previously explained, the choice of a materiality amount for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit. The auditor may use an amount based on a "size-of-business" benchmark such as assets or revenues to plan the scope of audit testing, but still use a "percentage-of-earnings" amount for the evaluation of audit findings. Thus, if assets or revenue are used to determine planning materiality, the auditor nonetheless probably would use the amount based on earnings to determine materiality for evaluating those audit differences that affect the income statement.

The selection of the appropriate benchmark is also affected by whether the entity operates in a specialized industry or area. For example, for a governmental entity, AU-C 320.A11 notes that total cost or net cost (expenses less revenues or expenditures less receipts) may be appropriate benchmarks for program activities. In another example, for nonprofit organizations, the allocation of costs among program and nonprogram activities is usually very important and total expenses may be a suitable benchmark. Specialized industries such as construction contracting also have unique considerations. The discussion of determination of planning materiality in this course is intended for the ordinary commercial entity. Other PPC guides provide guidance and practice aids tailored to the circumstances of entities in other industries.

Selecting a Percentage. There are no authoritative percentage guides for materiality. AU-C 320.A9 explains that a relationship exists between the percentage and the chosen benchmark. For example, a percentage applied to profit from continuing operations before tax will normally be higher than a percentage applied to total revenue. AU-C 320, however, contains no guidance or specific examples of appropriate percentages. Nevertheless, certain guidelines have evolved in audit practice.

Exhibit 3-1

Benchmarks and Associated Percentages Commonly Used in Practice

Benchmark	Associated Percentage Range
Total revenue	0.5% to 2.0%
Total assets	0.5% to 2.0%
Gross profit	1.0% to 2.0%
Pretax income	5.0% to 10.0%
Equity	1.0% to 5.0%
Cash flows from operations	3.0% to 5.0%

Several factors enter into the consideration of what point within the range of percentages for each benchmark the auditor ought to use. These factors include matters such as the stability versus volatility of the benchmark, the overall financial health of the entity, and the relative importance of the entity's working capital position. The auditor needs to consider the facts and circumstances of the particular entity and not automatically gravitate to the lower or higher end of the range. For example, when equity is determined to be

the appropriate benchmark because of focus on the entity's method of financing, and working capital is tight, the auditor may select a point at the lower end of the range.

* * *

The selection of a percentage from a range of percentages for a particular benchmark is influenced by the need to revise planning materiality as the audit progresses. As required by AU-C 320.12 and discussed further below, revision is necessary when information coming to the auditor's attention during the audit would have caused the auditor to determine a different amount initially. For example, if the auditor determines planning materiality before the financial statements to be audited are prepared, as is often the case, a change in the actual amount of the benchmark could substantially change the appropriate amount for planning materiality. If a lower materiality amount is appropriate, the auditor may determine that the nature, timing, and extent of further procedures is no longer appropriate as originally planned. For this reason, the auditor considers the entity's history of audit adjustments, the stability of operations, and similar matters in selecting the point within the range, and adjusts the point within the range accordingly. A history of frequent adjustments or volatility in the benchmark may lead to selecting a point at the lower end of the range to reduce the risk that a later downward revision of planning materiality and increase in audit scope will be necessary. Conversely, an entity with few if any audit adjustments and a relatively stable benchmark would normally permit selecting a percentage at the higher end of the range.

Sources of Information for Planning Materiality. The auditor can use amounts from the financial statements to be audited or from the trial balance from which those financial statements will be prepared except when the following occurs:

a. The financial statements (or trial balance) will not be available prior to performing detailed audit planning.

b. In past years, there have been significant audit adjustments to client accounting data.

c. Significant changes in the entity's circumstances indicate that current amounts are not representative of the entity's financial results or financial position. (For example, the current period subject to audit is affected by a nonrecurring charge, such as an impairment charge, or a change in circumstances has caused operating results to drop to approximately breakeven.)

In such circumstances, AU-C 320.A7 indicates that relevant financial data ordinarily includes prior period results and financial position, period-to-date results, and current budgets or forecasts, taking into account significant changes in entity circumstances and economic or industry conditions.

The appropriate source information for determining the benchmark and the need for adjustments to that information depends on the circumstances and the particular benchmark. If year-end financial statement balances are not available, the amount of total assets at an interim date generally may be used in the calculation. For example, if the November monthly financial statements are available, the November balance sheet amounts may be used for an entity with a calendar year-end. On the other hand, the income statement amounts for the 11-month period will have to be annualized. The same considerations as explained in Lesson 1 apply to using interim information in calculating planning materiality for the audit of the annual financial statements. The auditor considers seasonal or other factors that would cause a straight annualization to be inappropriate. For example, if the client has disproportionate December revenues, the auditor might add budgeted December revenues to the actual 11 months of revenues rather than annualizing the 11-month amount. When interim amounts are unavailable, when significant audit adjustments are expected, or when significant changes in the entity's circumstances have occurred, the auditor may use historical averages based on the past two or three years. For example, if net income or pretax income have dropped to near breakeven in the current period, the auditor could use an average amount of the prior three years as the benchmark. If there is a large nonrecurring charge in the current period, the auditor could adjust the net income or pretax income benchmark by removing the charge. The nature of the audit adjustments expected may also influence the choice of a benchmark, e.g., if adjustments have been primarily to the balance sheet only, total revenue or pretax income would be a better benchmark.

Planning materiality decisions need to be reconsidered as the audit progresses. AU-C 320.12 states that the auditor should revise materiality levels if the auditor becomes aware of information during the audit that would have caused

the auditor to determine a different amount(s) initially. Because the calculation made during initial planning often uses interim financial information, the amounts in the annual audited financial statements might differ. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments are made. AU-C 320.13 indicates that if the auditor concludes a lower materiality than initially determined is appropriate, the auditor should determine whether performance materiality has to be revised and whether the nature, timing, and extent of further audit procedures remain appropriate. If planning materiality based on interim amounts is too large, for example, then audit scope might not have been sufficient. If planning materiality based on interim amounts was too small, then the audit would be less efficient than would have been possible because the auditor will have done more audit work than was necessary.

Determining Materiality for Particular Items of Lesser Amounts

AU-C 320.10 indicates that in addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular classes of transactions, account balances, or disclosures of lesser amounts than planning materiality could be expected to influence economic decisions of users. Any such amounts determined represent lower materiality levels to be considered in relation to the particular classes of transactions, account balances, or disclosures in the financial statements for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor determines whether there are particular classes of transactions, account balances, or disclosures for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Many auditors believe, for example, that a lower materiality threshold is appropriate for related party transactions and balances.

AU-C 320.A12 suggests factors such as the following to consider in making this planning decision:

a. Whether accounting standards, laws, or regulations affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions and the remuneration of management and those charged with governance).

b. The key disclosures in relation to the industry and the environment in which the entity operates (for example, research and development costs for a pharmaceutical company).

c. Whether attention is focused on the financial performance of a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

The auditor ought to consider consulting with management and those charged with governance about whether there are particular financial statement items of lesser amounts than planning materiality that users would regard as material. However, the determination of such items is a decision based on consideration of the previously listed qualitative factors.

Another way of looking at determining materiality for particular items of lesser amounts is that it is an exception to the general notion that planning materiality is a primarily quantitative determination and opens the determination to several qualitative factors, but only for particular classes of transactions, account balances, or disclosures specified by the auditor. The following example illustrates the use of planning materiality for particular items of lesser amounts.

Example 3-1: Determining planning materiality for particular items of lesser amounts.

Adams Bowling Inc. acquired a new subsidiary during the year, Pinewood Pin Company. The acquisition was largely financed through a five-year financing facility from the principal lender of Adams. Based on discussions with management and the board of directors, as well as a review of the financing agreements, the auditor of Adams is aware that the lender is focused on the performance of the subsidiary as disclosed in consolidating financial statements of Adams. While the planning materiality level for the consolidated financial statements of Adams has been determined to be $550,000 based on its total assets, the auditor has decided to establish a lower planning materiality amount to be used when auditing the disclosures attributable to

Pinewood. In this case, the auditor has selected $125,000 after considering the total assets and revenues of Pinewood along with the views and expectations of management and the board of directors.

Lower levels of materiality for particular items in the financial statements should be documented.

Determining Performance Materiality

The auditor's objective is to perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. For this purpose, the auditor needs to establish a performance materiality amount(s) at the individual account balance, class of transaction, or disclosure level.

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. When applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

Performance materiality is distinguishable from tolerable misstatement. As explained in AU-C 320.A2, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. AU-C 530.A6 also provides the guidance that tolerable misstatement may be the same amount or an amount smaller than performance materiality. The AICPA Sampling Guide (paragraph 4.52) explains that tolerable misstatement might be viewed of as an extension of the concept of performance materiality used at the test level to accounts, balances or classes of transactions. In other words, *performance materiality* is materiality at the account balance or transaction class level. *Tolerable misstatement* is materiality at the test or procedure level, for a specific account balance or transaction class when that procedure or test is applied using audit sampling.

Considerations in Determining Performance Materiality. AU-C 320.A14 explains that determination of performance materiality is not a simple mechanical calculation. It involves the exercise of professional judgment and is affected by the following:

- The auditor's understanding of the entity.
- Any need for revision identified in the performance of risk assessment procedures.
- The nature and extent of misstatements identified in previous audits.
- The auditor's expectations regarding misstatements in the current period.

It may be helpful to consider the following:

- Performance materiality is a planning concept.
- Performance materiality is less than planning materiality.
- Performance materiality relates to the materiality level for a particular class of transactions, account balance, or disclosure.
- Performance materiality is set in a manner that reduces to an appropriately low level the probability that the aggregate of *uncorrected and undetected* misstatements exceeds the materiality level for the particular class of transactions, account balance, or disclosure.

Auditors need to establish at least one amount for performance materiality. However, differing amounts can be established for various transactions classes, accounts balances, and disclosures. Exhibit 3-2 provides factors that auditors may consider when establishing performance materiality. Because performance materiality is set at an

amount lower than planning materiality to allow for uncorrected and undetected misstatements, the exhibit illustrates the effect of the various factors on the potential allowance for undetected misstatement. For example, to achieve a higher allowance for undetected misstatement, performance materiality would need to be reduced in relation to planning materiality. The exhibit is adapted from Appendix J in the AICPA Risk Assessment Audit Guide.

Exhibit 3-2

Factors to Consider When Establishing Performance Materiality

Factor	Conditions That May Result in a Lower Performance Materiality	Conditions That May Result in a Higher Performance Materiality	Comments
Total expected factual, judgmental, and projected misstatements	Greater amount of expected misstatements	Lower amount of expected misstatements	Allowance for undetected misstatement is normally higher when more misstatements are identified.
Management's willingness to make proposed adjustments	Management resists making adjustments	Management corrects factual and many judgmental misstatements	Allowance for undetected misstatements can be lessened when misstatements are adjusted.
Number of accounts involving management estimation	Significant number of accounts require estimation	Few accounts require estimation	Allowance for undetected misstatements would normally increase when there are significant amounts subject to estimation.
Locations, subsidiaries, or samples within an account where separate procedures are applied for each location and are aggregated in reaching audit conclusions	Significant number of locations, subsidiaries, or samples within an account	Few locations, subsidiaries, or samples within an account	Allowance for undetected misstatements is normally higher given the imprecision of many samples.

* * *

The factors in Exhibit 3-2 are also considered when establishing tolerable misstatement for sampling purposes. To the extent that these factors are considered when determining performance materiality, tolerable misstatement might be equal to performance materiality.

A Practical Approach to Determining Performance Materiality. Professional standards do not discuss precisely how performance materiality is to be determined. At the conclusion of the audit, the auditor needs to be able to reach the judgment that the risk is relatively low that the financial statements as a whole are materially misstated. This ultimate objective can provide a general conceptual framework for determining performance materiality.

Conceptually, the aggregate of misstatements for a particular class of transactions, account balance, or disclosure, which consists of detected but uncorrected misstatements and undetected misstatements, cannot exceed the amount for that class, balance, or disclosure that would materially misstate the financial statements as a whole. The aggregate amount for the financial statements as a whole at the planning stage of the audit is planning materiality. Thus, the residual of planning materiality less aggregate detected and uncorrected misstatement would be

performance materiality, which in this framework is an allowance for undetected misstatement. The uncorrected misstatement is the aggregation of factual misstatement plus projected and judgmental misstatement from the application of audit procedures using audit sampling and analytical procedures, respectively, less the misstatement the client agrees to correct.

At the planning stage, the auditor cannot know the amounts of *factual misstatements* that will be detected and that the client will not correct, or the *projected or judgmental misstatements* that will result from the application of audit procedures using audit sampling or analytical procedures. However, the auditor may be able to make reasonable estimates of those amounts. In that case, the auditor could deduct the sum of those estimates from planning materiality to estimate performance materiality. However, because of the difficulty of making these estimates, many auditors prefer to use a rule of thumb approach that produces satisfactory results in most circumstances as discussed in the following paragraph.

The approach suggested by this course using the framework described above is to determine performance materiality as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level (and materiality for items of lesser amounts, if applicable) with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases. Appendix J of the AICPA Risk Assessment Audit Guide also supports using a guideline of 50% to 75% when setting performance materiality. Likewise, the AICPA Audit Guide, *Audit Sampling*, notes as practical guidance that tolerable misstatement ranges of 50% to 75% of materiality has often been shown to be adequate to allow for the factors influencing the performance materiality and tolerable misstatement amount.

The 50% guideline is based on the maximum adjustment normally made in monetary unit (MUS) sampling applications to allow for the projected misstatements expected in sample results. Usually this 50% adjustment is conservative, that is, the extent of testing will be greater than necessary. Typically, for most nonpublic entities, the larger adjustment of 75% will be satisfactory. When the auditor expects a relatively large amount of factual misstatements to remain uncorrected or relatively large judgmental or projected misstatements (or other factors in Exhibit 3-2 exist that would increase the allowance for undetected misstatement), an adjustment closer to 50% is necessary. Although this rule of thumb was developed for sampling applications, it may also be useful and it seems to produce appropriate results for audit areas for which a nonsampling audit approach is used. This is true, in large part, because the performance materiality amount is a planning tool used to determine that adequate audit work is performed to achieve audit objectives and not an amount used to evaluate whether the misstatement of a particular class, balance, or disclosure is material.

Implementing Performance Materiality. The scope of audit procedures for specific account balances and transaction classes is clearly affected in important ways by materiality. Using an explicit amount for performance materiality permits the auditor's decisions about the quality and extent of evidence necessary to be influenced specifically by the size of a misstatement that would be material to the account balance, transaction class, or disclosure.

Use of performance materiality for individual classes of transactions, account balances, and disclosures is appropriate because it is not efficient or effective to apply a percentage guide to each account. For example, in applying audit procedures to prepaid expense, it would not be reasonable to regard 10% of the balance as material if the total amount of prepaid expense was immaterial to the financial statements. For some accounts and transactions, consideration of performance materiality is not essential because the nature of the item and cost of possible audit procedures is such that the account can be audited to very close tolerances. For example, long-term debt and property, plant, and equipment can usually be examined to close tolerances. For other accounts, such as receivables and inventory, consideration of performance materiality for the account balance may be necessary in making planning decisions. An auditor, for example, might use the performance materiality amount in deciding—

a. which items in a balance to examine 100%,

b. whether it is necessary to sample the remaining items, or

c. whether to apply analytical procedures instead of tests of details.

Deciding Whether to Extend Procedures. Amounts calculated for planning materiality and performance materiality are used in initially planning the nature, timing and extent of audit procedures. During the audit, an auditor may detect some misstatements in an account balance and may need to decide whether to apply additional procedures. In those circumstances, the auditor does not compare the potential misstatement to planning materiality, performance materiality, or tolerable misstatement. The appropriate comparison for this purpose is to the calculated individually significant amount.

Clearly Trivial Misstatements

As indicated at AU-C 450.05–.11, auditors are required to accumulate and evaluate misstatements detected during the audit, other than those that are clearly trivial. The amount determined to be clearly trivial is the level for accumulating misstatements during the concluding audit work and is sometimes called the nonposting threshold. Misstatements detected in a particular audit area below this amount are not posted to the summary of audit differences. The clearly trivial misstatement amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered. If the amount is set too high, the auditor might be exposed to material misstatements in the financial statements. If the amount is set too low, the auditor might encounter inefficiencies dealing with immaterial misstatements. A practical rule of thumb for designating clearly trivial misstatements is to use 3%–5% of planning materiality, depending on expectations about misstatements. As is the case for all rules of thumb, this approach cannot be applied mechanically. For example, if the auditor expects a large number of small misstatements or becomes aware that misstatements passed at the workpaper level are tending to go in one direction, the auditor might lower the threshold for clearly trivial misstatements. Auditors should document the amount of misstatements that will be passed at the workpaper level.

When determining whether the amount of a misstatement is below the amount that will be accumulated on the summary of audit differences, the auditor needs to be careful not to net proposed adjustments at the workpaper level without first considering the risk of further undetected misstatements. AU-C 450.A21 indicates that offsetting misstatements within the same account balance or class of transactions may be appropriate, but the risk that further undetected misstatements exist has to be considered before offsetting even immaterial misstatements. For example, assume the auditor has determined that only misstatements greater than $500 need to be accumulated on the summary of audit differences. If the auditor has a factual misstatement that overstates income by $10,000 and a judgmental or projected misstatement that understates income by $10,550, it would ordinarily be a best practice to include both misstatements on the summary of audit differences. AU-C 450.A21 further notes that auditors might need to reassess risks of material misstatement for a specific account balance or class of transactions when a number of immaterial misstatements are identified for that account balance or class of transactions.

Documentation Requirements—Materiality

AU-C 320.14 requires the auditor to document the following relating to materiality, including factors considered in their determination:

a. Materiality at the financial statement level.

b. If applicable, materiality level(s) for particular transaction classes, account balances, or disclosures.

c. Performance materiality.

d. Revisions, if any, as the audit progressed from a. through c. above.

AU-C 450.12 requires the auditor to document the amount below which misstatements would be considered clearly trivial. Although the documentation requirements related to materiality are limited to the preceding matters, auditors can include more extensive documentation of the auditor's reasoning process in making these materiality-related determinations. The auditor may wish to document, among other matters, the expected users, or categories of users, of the audited financial statements; the key factors that affect the choice of the benchmark and, if applicable, the point within the range of percentages applied to the benchmark; the reasons for any adjustment of the benchmark; and the calculation of the ratio of the planning materiality amount to important totals and subtotals in the financial statements.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.

AU-C 315.03 states that "the objective of the auditor is to identify and assess the risks of material misstatement, whether due to error or fraud, at the financial statement and relevant assertion levels." These risks are identified and assessed by obtaining an understanding of the entity and its environment including its internal control, and this understanding provides a basis for designing and implementing responses to the assessed risks of material misstatement.

Risks of material misstatement at the financial statement level often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. These overall risks are often especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. Risks at the financial statement level might also relate to the process of preparing the financial statements, the selection and application of significant accounting policies, entity-level controls other than the control environment, and IT general controls. As with risks at the assertion level, the auditor needs to consider identified risks at the financial statement level in terms of what can go wrong in the financial statements.

At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk. Some auditors have questioned whether these risk model components also need to be considered at the financial statement level. The answer is, "No." Risk assessment at the financial statement level seems to be directed to an overall or combined assessment of the risk of material misstatement. There is no requirement to separately assess inherent risk and control risk at the financial statement level. The overall assessment of risks of material misstatement at the financial statement level is made relatively early in audit planning, based on information such as the effectiveness of the entity's control environment and identification of fraud risk factors.

Responding to Risks at the Financial Statement Level. AU-C 330.05 states that "the auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level." AU-C 330.A1 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include—

- Emphasis to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills or using specialists.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

In addition, the auditor should consider any specific relevant assertions that might be affected by the overall risks and develop responses at that level when designing the nature, timing, and extent of further audit procedures.

To introduce an element of unpredictability, it is a best practice for the auditor needs to avoid always selecting only items above a cutoff dollar amount, particularly when that cutoff amount does not vary significantly from year to year. The auditor can make a haphazard selection to test items below the cutoff amount to avoid providing client personnel with a roadmap of how to circumvent the audit approach.

Exhibit 3-3 provides examples of overall risks and potential responses.

Exhibit 3-3

Examples of Overall Risks and Responses

Overall Risk	Example Responses
No communication of ethical values. Management exhibits behavior that occasionally reflects a loose regard for ethical business practices. (The auditor assumes a risk of management override of controls. This also assumes that the auditor does not perceive the risk to be so great to either decline or withdraw from the engagement.)	• Place higher emphasis on the use of professional skepticism. • Assign staff with higher experience levels. • Review accounting estimates for bias. • Evaluate business rationale for unusual transactions. • Examine more journal entries, particularly nonstandard journal entries. • Make greater use of unpredictability in audit procedures. • Increase the extent of fraud-related inquiries.
Turnover in key management during the year.	• Increase the level of supervision. • Review accounting estimates for bias. • Evaluate more closely the business rationale for unusual transactions.
Going concern considerations that may impact future financing, business investment, or other business opportunities.	• Increase the level of supervision or assign more experienced staff. • Shift substantive procedures to year end. • Review accounting estimates for bias. • Emphasize the use of professional skepticism.
A minimal degree of compliance with restrictive loan covenants containing various required operating ratios for significant financing agreements.	• Shift substantive procedures to year end. • Review accounting estimates for bias.
Management exhibits a low regard for hiring competent finance personnel.	• Increase the level of supervision or assign more experienced staff. • Shift substantive procedures to year-end.

* * *

Because there is always a risk of management override of controls, AU-C 240.29 states that certain overall responses are required in every audit, as follows:

- Auditors should consider the knowledge, skill, and ability of individual engagement team members and the fraud risk assessment when assigning and supervising personnel.

- Auditors should evaluate the client's selection and application of accounting principles, especially in subjective areas.

- Auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks. Exhibit 3-4 provides examples of overall responses to fraud risks.

Exhibit 3-4

Overall Responses to Fraud Risks

Staffing and Supervision:

- Assignment of more experienced audit personnel to the engagement or increased supervision of engagement personnel.
- Assignment of personnel with industry or functional expertise.
- Involvement of specialists.

Selection and Application of Accounting Principles:

- Increased scrutiny of the client's selection and application of significant accounting policies, particularly those that deal with revenue recognition, asset valuation, or capitalizing versus expensing.

Incorporating an Element of Unpredictability:

- Altering the timing of tests.
- Changing sampling methods.
- Performing procedures at different locations or on an unannounced basis.
- Performing a different combination of substantive analytical procedures and tests of details.
- Testing account balances and assertions otherwise considered immaterial or low risk.

Other Overall Responses:

- Increased sensitivity to the nature, timing, and extent of documentation examined in support of material transactions.
- Increased recognition of the need to corroborate client explanations or representations concerning material matters, such as through additional analytical procedures, examination of documentation, or corroboration with others within or outside the company.
- Further consideration of the auditor's control risk assessment (if control risk has been assessed at less than a high level) if identified fraud risks have control implications.
- Increased scrutiny of the nature and business reasons for unusual and/or overly complex transactions.

* * *

Documentation. AU-C 315.33 requires the auditor to document the identified and assessed risks of material misstatement at the financial statement level. AU-C 330.30 requires the auditor to document the overall responses to address the assessed risks of material misstatement at the financial statement level. Thus, the auditor needs to include in audit documentation both the identified and assessed risks at the financial statement level and the overall responses to them.

Establishing an Overall Audit Strategy

AU-C 300.07 states that the auditor should establish an overall strategy for the audit. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach, and it includes the identification of overall risks, overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. Determination of audit strategy would normally be the responsibility of more senior and experienced members of the audit team, including the audit partner, given the judgments that are required.

AU-C 300.08 provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the key characteristics of the engagement that define its scope.

b. Determine the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the following:

(1) Significant factors that will determine the focus of the engagement team's efforts.

(2) Results of preliminary engagement activities.

(3) If applicable, the knowledge from other engagements performed for the entity.

d. Determine the nature, timing, and extent of resources needed to perform the audit.

Steps a. and b. are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be needed. Step c.(1) is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level. Steps c.(2) and c.(3) concern additional information that also may affect the focus of the engagement team's efforts. Finally, step d. concerns the personnel resources that will be necessary to accomplish audit objectives, including the need for the involvement of specialists and other experts.

Characteristics of the Engagement. The characteristics of the engagement that define its scope generally include the following:

- The financial reporting framework on which the financial information to be audited has been prepared; for example, GAAP, cash basis, or regulatory basis, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components.
- The nature of control relationships between a parent and components that determine consolidation of the group.
- The extent that other components are audited by other auditors.
- The nature of business divisions to be audited and the need for specialized knowledge.
- The need for any translation into the reporting currency.
- Statutory or regulatory requirements.
- The availability of the work of internal auditors and the auditor's potential use of that work.
- The entity's use of service organizations.
- The expected use of audit evidence from previous audits.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques (CAAT).
- Coordination of the expected coverage and timing of the work with any reviews of interim financial information.
- Availability of client personnel and data.

Reporting Objectives, Audit Timing, and Nature of Communications. The reporting objectives, nature of communications, and timing of the audit generally include the following:

- Deadlines for interim and final reporting.
- Discussions with management and those charged with governance about audit work, reporting, other communications, and other deliverables both during the audit and at its conclusion.
- Communication with auditors of components concerning types and timing of reports and other communications.
- The expected nature and timing of communications among engagement team members, including the nature and timing of review of work performed.
- Statutory or contractual reporting responsibilities, for example, a special report on compliance with debt covenants.

Significant Engagement Factors, Results of Preliminary Engagement Activities, and Knowledge Gained on Other Engagements. Important aspects of overall audit strategy that determine the focus of the engagement team's efforts generally include the following:

- Materiality considerations, including—
  - Planning materiality.
  - Materiality for components and component auditors.
  - Preliminary identification of significant components and material classes of transactions, account balances, and disclosures.
- Preliminary identification of areas where there may be higher risks of material misstatement, including those due to fraud.
- Effect of assessed risks of material misstatement at the overall financial statement level.
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and action taken to address them.
- Discussion of matters with firm personnel responsible for performing other engagements for the entity.
- Evidence of management's commitment to sound internal control, and importance attached to internal control, including appropriate documentation.
- Volume of transactions.
- Significant changes in accounting standards.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Manner of emphasizing the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the balance sheet date rather than at an interim date.
- Identification of recent significant developments affecting the entity, its industry, its financial reporting, or its legal or economic environment.

- Determination of areas where client assistance is expected to be minimal.

- Determination of whether the work of the internal audit function will be used to obtain audit evidence or whether internal auditors will be used to provide direct assistance.

Nature, Timing, and Extent of Resources. In developing the overall audit strategy the auditor incorporates decisions and judgments about overall responses to the risks of material misstatement at the financial statement level as previously discussed. A key outcome of developing the strategy is the determination of resources necessary to perform the engagement including:

- *Overall Personnel Resources.* This includes the determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit work to team members, especially the assignment of appropriately experienced team members to areas identified as having higher risks of material misstatement. The auditor also considers the extent of involvement of professionals possessing specialized skills. In addition, the timing of personnel deployment and engagement budgeting, especially for areas with higher risk, are considered.

- *Management and Supervision of Personnel.* This includes management and supervision considerations such as team briefing meetings, reviews by the partner and manager, and quality control reviews.

Timing of Further Audit Procedures. As part of the audit strategy, an auditor considers whether to apply any substantive procedures or tests of controls before the balance sheet date. Generally, the most efficient approach for audits of small and midsize nonpublic entities is to perform the audit tests as of the balance sheet date. However, the auditor may wish to perform audit procedures before the balance sheet date in the following situations:

- *Convenience.* If the auditor has several clients with the same year end, interim procedures may be used to spread the auditor's workload more evenly.

- *Deadline.* If the client has a tight deadline for issuing its financial statements, the auditor may need to perform some procedures at an interim date to meet that deadline.

AU-C 330.A12 observes that the auditor may perform tests of controls or substantive procedures at an interim date or at period-end, and that the higher the risk of material misstatement, the more likely it is that the auditor may decide to perform substantive procedures nearer to or at period-end.

Small Business Considerations. One of the primary characteristics of a small business is concentration of ownership or operational control in one or a few individuals. This characteristic has important influences on preliminary planning, particularly the audit strategy that is most effective for a small business engagement. This course suggests that an audit strategy that is efficient and effective for a large entity may not be so for a small business client and that ignoring the unique characteristics of a small business usually leads to overauditing. The primary characteristics of a small business that influence audit strategy are as follows:

a. Concentration of ownership or operational control in one or a few individuals.

b. Limited segregation of duties and functions within the accounting system.

These characteristics generally mean that the most efficient and effective audit strategy for a small business engagement is to take a primarily substantive approach to the audit. Under a substantive approach, the basis for an auditor's opinion on the financial statements is evidence obtained from substantive procedures, rather than a combination of tests of controls and substantive procedures. Also, it seems likely that if the characteristics of the small business are ignored, the auditor will spend more time and effort documenting control activities than is really necessary and will usually be both ineffective and inefficient. Substantive procedures will not be properly designed, with the result that key procedures may be omitted and unnecessary procedures will almost always be included.

As explained in Lesson 2, auditors are required to understand the design and implementation of internal controls and to document the understanding of the five components of internal control and the sources of information used and procedures performed to obtain that understanding, even if the audit strategy will be a primarily substantive

approach. However, before deciding not to test controls, auditors need to be satisfied that performing only substantive procedures will be effective in reducing detection risk to an acceptable level. How information technology (IT) may affect an auditor's decision to adopt an audit strategy that is a primarily substantive approach is discussed later in this lesson.

Effect of Information Technology (IT) on Audit Strategy. A client's IT system also can affect the audit strategy because it can affect the risks of material misstatement, which influence the auditor's substantive procedures, and also can affect the availability and sufficiency of audit evidence, including the audit trail. In financial reporting systems, much of the client's data is processed and stored only in electronic form. Thus, errors and fraud involving IT systems and files may be less obvious than misstatements in manual records. Also, data processing duties are often concentrated in one or two employees. Those factors can create a higher risk of material misstatement. However, risks may be reduced if the client uses only purchased software and simple applications.

In addition, when information is available only in electronic form, its sufficiency as audit evidence usually depend on the effectiveness of controls over its accuracy and completeness. Accordingly, the risk of improper initiation or alteration of information may be greater if the information is available only in electronic form and controls are not operating effectively. For example, automated controls and processes may be overridden leaving little or no visible evidence of the intervention. In that case, the auditor needs to perform tests of controls to gather evidence for use in assessing control risk.

Before designing the audit plan, auditors consider whether the client's IT system provides a clear audit trail. If the system does not provide a clear trail for posting transactions to the general ledger, including journal entries, the auditor may need to change the nature of planned substantive procedures, such as testing items comprising year-end balances instead of testing transaction activity for the period.

Auditors also consider the amount and type of available data when designing audit procedures. They may need to time tests based on when the accounting data is available. Data availability can be affected by both the IT system and the client's data retention policies.

The impact of IT on an entity's internal control is generally related more to the nature and complexity of the entity's systems than to the entity's size. However, before deciding not to test controls, auditors need to be satisfied that performing only substantive procedures will be effective in reducing detection risk to an acceptable level. For example, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the relevant assertion level when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system.

Other Audit Strategy Considerations. The following issues also may affect auditor's responsibilities in audits of financial statements of certain entities and, when relevant, are considered as part of the overall audit strategy:

a. Service organizations provide services that are part of an entity's information system.

b. Specialists are used in an audit. (For example, appraisers that value real estate collateral for a note receivable, valuation specialists that value businesses, derivatives, or certain types of assets, or actuaries that perform complex calculations, such as determination of future employee benefits or self-insurance loss reserves.)

c. Group financial statements.

Timing of Developing the Audit Strategy. In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in client circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or component auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information throughout the performance of the risk assessment procedures to complete the overall audit strategy.

Revising the Initial Audit Strategy. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement. Changes should be documented, as discussed below.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. AU-C 260.11 requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. AU-C 300.14 requires that the auditor document the overall audit strategy, the audit plan, any significant changes made to them during the audit, and the reasons. Professional standards do not necessarily require that a separate audit strategy memorandum be prepared to document in one place all matters that affect the audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the entity and its environment.

An efficient approach to documenting the audit strategy, and any changes to it, in the audit of a small, noncomplex, nonpublic company is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, and then update and change it in the current period to provide a basis for planning the current audit. The update can be based on discussions with management or the owner/manager of the entity. As a practical matter, some auditors frequently prepare an "audit (or engagement) summary memo" as part of their engagement completion procedures to provide a convenient method of establishing a basis for planning the following year's audit engagement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following guidance could help an auditor establish planning materiality?

    a. Selection of an appropriate benchmark is relatively standard industrywide.

    b. Typically, a single benchmark is preferable to multiple benchmarks.

    c. If multiple benchmarks seem appropriate, an average can be used.

    d. The auditor's judgment about materiality is affected most by the client's needs.

22. When determining his client's planning materiality, Lucas selects cash flows from operations as the most meaningful benchmark. What associated percentage range should Lucas use with this benchmark?

    a. 0.5% to 2.0%.

    b. 1.0% to 2.0%.

    c. 1.0% to 5.0%.

    d. 3.0% to 5.0%.

23. Performance materiality—

    a. Is a mechanical calculation.

    b. Is greater than planning materiality.

    c. Can be multiple amounts.

    d. Should be determined per professional standards.

24. An auditor may do which of the following when determining performance materiality?

    a. Add undetected and uncorrected misstatements to the residual of planning materiality.

    b. Deduct the sum of estimated factual and judgmental misstatements from planning materiality.

    c. Calculate performance materiality as a fraction between 25% and 50% of materiality.

    d. Apply percentages to each of the audit client's accounts.

25. Which of the following statements applies when the auditor establishes his or her overall audit strategy?

    a. The most effective and efficient plan is for auditors to perform audit tests before the balance sheet date.

    b. The client's IT system is a separate consideration and will not affect the audit strategy.

    c. Auditors can establish their preliminary audit strategy before performing many risk assessment procedures.

    d. Once set, the auditor should not change the initial audit strategy to provide continuity to the engagement.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Which of the following guidance could help an auditor establish planning materiality? **(Page 241)**

    a. Selection of an appropriate benchmark is relatively standard industrywide. [This answer is incorrect. The appropriateness of a benchmark and the related appropriate percentage vary with the circumstances. They would not be the same for all audit clients in the same industry.]

    b. Typically, a single benchmark is preferable to multiple benchmarks. [This answer is correct. One reason for the desirability of a single benchmark arises from the practical requirements of audit planning. In planning, the auditor does not know in advance whether the misstatements that will be detected by a particular audit procedure will affect the balance sheet only, the income statement only, or both statements. Thus, using several levels of materiality is impractical in planning.]

    c. If multiple benchmarks seem appropriate, an average can be used. [This answer is incorrect. Auditors typically do not use an average of several benchmarks because a simple average would dilute the effect of the most important benchmark, and weighting benchmarks is overly complicated and not supported by common practice.]

    d. The auditor's judgment about materiality is affected most by the client's needs. [This answer is incorrect. AU-C 320 indicates that the auditor's judgment about the determination of materiality is affected by the auditor's perception of the financial information needs of users. Financial statement users are not limited to those in the client itself.]

22. When determining his client's planning materiality, Lucas selects cash flows from operations as the most meaningful benchmark. What associated percentage range should Lucas use with this benchmark? **(Page 243)**

    a. 0.5% to 2.0%. [This answer is incorrect. This percentage range would be appropriate if Lucas used either total revenue or total assets as the benchmark.]

    b. 1.0% to 2.0%. [This answer is incorrect. If Lucas selected gross profit as the benchmark, this percentage range would be appropriate.]

    c. 1.0% to 5.0%. [This answer is incorrect. This percentage range would be useful to Lucas if he selected equity as the benchmark for his engagement.]

    d. 3.0% to 5.0%. [This answer is correct. There are no authoritative percentage guides for materiality. AU-C 320.A9 explains that a relationship exists between the percentage and the chosen benchmark. However, it contains no guidance or specific examples of appropriate percentages. Nevertheless, certain guidelines have evolved in audit practice. Therefore, if Lucas chooses cash flows from operations as his benchmark, an appropriate percentage range (based on common practice) is 3.0% to 5.0%.]

23. Performance materiality— **(Page 246)**

    a. Is a mechanical calculation. [This answer is incorrect. AU-C 320.A14 explains that determination of performance materiality is *not* a simple mechanical calculation. It involves the exercise of professional judgment and is affected by other factors, such as the auditor's understanding of the entity.]

    b. Is greater than planning materiality. [This answer is incorrect. Actually, performance materiality should be *less than* planning materiality, not greater than.]

    c. Can be multiple amounts. [This answer is correct. Auditors need to establish at least one amount for performance materiality. However, differing amounts can be established for various transaction classes, account balances, and disclosures.]

    d. Should be determined per professional standards. [This answer is incorrect. Professional standards *do not* discuss precisely how performance materiality is to be determined. At the conclusion of the audit, the auditor needs to be able to reach the judgment that the risk is relatively low that the financial statements as a whole are materially misstated. This ultimate objective can provide a general conceptual framework for determining performance materiality.]

24. An auditor may do which of the following when determining performance materiality? **(Page 248)**

    a. Add undetected and uncorrected misstatements to the residual of planning materiality. [This answer is incorrect. Conceptually, the aggregate of misstatements for a particular class of transactions, account balance, or disclosure, which consists of detected but uncorrected misstatements and undetected misstatements cannot exceed the amount for that class, balance, or disclosure that would materially misstate the financial statements as a whole. The aggregate amount for the financial statements as a whole at the planning stage of the audit is planning materiality. Thus, the residual of planning materiality *less* aggregate detected and uncorrected misstatement would be performance materiality, which in this framework is an allowance for undetected misstatement.]

    b. Deduct the sum of estimated factual and judgmental misstatements from planning materiality. [This answer is correct. At the planning stage, the auditor cannot know the amounts of factual misstatements that will be detected and that the client will not correct, or the projected or judgmental misstatements that will result from the application of audit procedures using audit sampling or analytical procedures. However, the auditor may be able to make reasonable estimates of those amounts. In that case, the auditor could deduct the sum of those estimates from planning materiality to estimate performance materiality.]

    c. Calculate performance materiality as a fraction between 25% and 50% of materiality. [This answer is incorrect. Performance materiality can be calculated as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level with the percentage being increased to 50% as the likelihood of uncorrected and undetected misstatements decreases.]

    d. Apply percentages to each of the audit client's accounts. [This answer is incorrect. Use of performance materiality for individual classes of transactions, account balances, and disclosures is appropriate because it is not efficient or effective to apply a percentage guide to each account.]

25. Which of the following statements applies when the auditor establishes his or her overall audit strategy? **(Page 256)**

    a. The most effective and efficient plan is for auditors to perform audit tests before the balance sheet date. [This answer is incorrect. As part of the audit strategy, an auditor considers whether to apply any substantive procedures or tests of controls before the balance sheet date. Generally, the most efficient approach for audits of small and midsize nonpublic entities is to perform audit tests as of the balance sheet date. While there may be specific situations when auditors wish to perform audit procedures before the balance sheet date, it is not the default.]

    b. The client's IT system is a separate consideration and will not affect the audit strategy. [This answer is incorrect. A client's IT system can affect the audit strategy because it can affect the risks of material misstatement, which influence the auditor's substantive procedures, and also can affect the availability and sufficiency of audit evidence, including the audit trail.]

    c. Auditors can establish their preliminary audit strategy before performing many risk assessment procedures. [This answer is correct. In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in client circumstances.]

    d. Once set, the auditor should not change the initial audit strategy to provide continuity to the engagement. [This answer is incorrect. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement. Changes should be documented.]

THE AUDITOR'S CONSIDERATION OF FRAUD

AU-C 240 establishes standards and provides guidance on the auditor's responsibility to consider the risks of fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated. This course discusses the auditor's assessment of audit risk at the financial statement level. (A discussion of the assessment at the account balance or transaction class levels is beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Nonpublic Companies*). Because the auditor's consideration of fraud is not separate from consideration of risk at those levels, this *Guide* integrates the requirements of AU-C 240 within the overall risk assessment process. This section, like AU-C 240, provides more specific guidance on assessing the risk of material misstatement due to fraud when assessing the risk of material misstatement. Although the requirements and guidance presented in this section may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the financial statements, and the procedures outlined in this section may be performed concurrently with other procedures. The evaluation of fraud risks occurs continuously throughout the audit.

Types of Misstatements Caused by Fraud

Fraud is a broad legal concept, but from an audit perspective is an intentional act that results in a misstatement in financial statements that are the subject of an audit. There are three conditions that generally are present when fraud occurs:

- *Incentive/Pressure.* Management or other employees have a reason to commit fraud.
- *Opportunity.* Circumstances, such as ineffective controls, the absence of controls, or the ability to override controls, enable management or other employees to commit fraud.
- *Attitude/Rationalization.* Management or other employees are able to justify the acceptability of committing fraud.

There are two types of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements resulting from fraudulent financial reporting.
- Misstatements resulting from misappropriation of assets.

AU-C 240.A1 explains that fraud, whether fraudulent financial reporting or misappropriation of assets, involves the three conditions enumerated above, and AU-C 240.A75 (Appendix A) provides examples of fraud risk factors classified by these conditions for each of the two types of fraudulent misstatements.

Misstatements Resulting from Fraudulent Financial Reporting. Misstatements resulting from fraudulent financial reporting (often referred to as management fraud or *cooking the books*) are intentional misstatements, or omissions, of amounts or disclosures from the financial statements with the intent of deceiving financial statement users. The effect of those misstatements causes the financial statements not to be presented, in all material respects, in conformity with GAAP. Examples that may be encountered include:

- Overstating revenue or income to earn higher bonuses.
- Overstating assets or understating liabilities to comply with debt covenants.
- Understating income to minimize income taxes.

In general terms, financial statements are fraudulently misstated through use of the following methods:

- Intentional misapplication of GAAP involving measurement and resulting misstatement of amounts.
- Intentional omission or misrepresentation of information about transactions or events (or intentional misapplication of GAAP involving disclosure).
- Recording fictitious transactions.
- Recording sham transactions (transactions without economic substance, usually involving related parties).

These methods may be facilitated by the creation, falsification, alteration, or other manipulation of accounting records or source documents. Misstatements resulting from fraudulent financial reporting are frequently perpetrated by management through override of internal controls over financial reporting.

Misstatements Resulting from Misappropriation of Assets. Misstatements resulting from misappropriation of assets (often referred to as defalcation, embezzlement, theft, or employee fraud) involve theft of the entity's assets that results in the financial statements not being presented, in all material respects, in conformity with GAAP. Misappropriation of assets can be committed in many ways, including embezzlement of cash receipts, stealing assets, or causing the entity to pay for goods and services not received (or paying inflated prices for goods and services received). This type of fraud may be facilitated by the falsification, alteration, or other manipulation of accounting records or source documents, possibly by circumventing controls. Misappropriation may be committed by one or more individuals in management, by employees, or by third parties. Some misstatements resulting from misappropriation of assets might result in misclassifications in the financial statements. For example, if an employee diverts cash for personal use by establishing a fictitious vendor and submitting falsified invoices coded to cost of goods sold, amounts reflected in the income statement may be misclassified assuming the amounts are not recoverable.

The Auditor's Responsibility for Fraud Detection

AU-C 240.05 explains that the auditor "is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement whether caused by fraud or error." AU-C 240 requires the auditor to specifically identify and assess risks that may result in material misstatement of the financial statements due to fraud and to respond to the results of the assessment when gathering and evaluating audit evidence. When assessing the risk of material misstatement due to fraud, the auditor considers the type of risk, that is, whether it relates to cooking the books or stealing; the significance of the risk, that is, whether it could result in material misstatement of the financial statements; the likelihood of fraud occurring; and the pervasiveness of the risk, that is, whether it relates to the financial statements as a whole or to specific areas of the financial statements and specific assertions within those areas. This analysis also includes consideration of the direction of the risk for the area of the financial statements that would be affected. Is the risk of potential misstatement a risk of overstatement (existence or occurrence) or a risk of understatement (completeness)?

The auditor considers who would have the motivation or incentive to intentionally misstate the financial statements and the form the fraud would be likely to take. As explained in Lesson 1, according to AU-C 240.15, this is a consideration that should be discussed among the engagement team members in a planning meeting. That way, team members can exchange ideas about where the audited entity's financial statements might be susceptible to misstatement due to fraud and the more experienced members can share their insights based on their knowledge of the entity. Key members of the audit engagement team need to have, and document, a brainstorming discussion early in the audit about the potential for fraud. Lesson 1 discusses who ought to attend the meeting and the matters that should be discussed at the meeting. The discussion and matters discussed should be documented.

Fraudulent Financial Reporting. The management of some nonpublic companies might be under pressure to produce income that meets expectations of certain outside parties (such as banks, venture capital firms, or potential investors) or absentee owners. Management might also be motivated to overstate income if their performance evaluation or compensation is tied to attainment of certain operating results. The desire to overstate income could lead to overstated revenues and related assets, or understated expenses accompanied by understated liabilities or overstated assets. In debit and credit terms, the credit achieves the inflation of earnings, but the

companion debit has to be concealed in an overstated asset or an understated liability. For example, management might overstate revenues and overstate receivables to inflate income or overstate ending inventory to understate cost of sales to achieve the same end. If management desperately needs to obtain financing, there might be an incentive to inflate income. If the borrowing base for the loan is receivables and inventory, there would be an incentive to overstate those assets and no need to inflate income. The auditor has to draw on knowledge of the business to evaluate where in the financial statements material misstatement due to fraud would be likely to exist. For example, revenue overstatement frauds tend to be more likely when there are a small number of individually material sales transactions.

For some small to medium-sized nonpublic entities, the risk may run in the opposite direction. There could be significant incentive to understate income to minimize income taxes. For all nonpublic companies, the auditor ought to be alert to signs of an excessive interest by management in either increasing income or pursuing inappropriate means to minimize taxable income. If the auditor believes there is a serious risk of tax-motivated fraudulent reporting, the auditor might then consider where the financial statements would be affected. Can cash receipts be removed before recording? If someone wanted to skim revenue, how would he or she do it? Other common means of reducing taxes are to inflate expenses by understating ending inventory or by charging personal expenses to the business. The auditor needs to distinguish between appropriate and inappropriate actions to reduce taxes. Aggressive tax positions are not the same as fraudulent actions such as skimming and falsifying documents. The independent auditor's focus is on whether the financial statements are materially misstated. Considering whether fraud risk factors are present (discussed in Lesson 1) provides information useful in evaluating potential types of misstatements.

Misappropriation of Assets. For a small to medium-sized nonpublic entity, the risk of misstatement arising from stealing is also always an important consideration. Cash is generally susceptible to stealing, and the auditor considers the handling of cash in conjunction with the processing of cash receipts and disbursements. The auditor needs a sufficient understanding of control activities to evaluate this risk. Can cash receipts be intercepted and stolen before accountability is established? This consideration is similar to the evaluation of the risks of skimming. The difference is that the benefit is to an employee rather than an owner who benefits by avoiding paying taxes. Can unauthorized cash disbursements occur and not be detected by reconciliation procedures? For example, this could occur if the controller writes checks and controls the bank reconciliation. The auditor might also consider whether assets with a high intrinsic value in the hands of an outside custodian, such as securities held by a broker, are susceptible to theft by means of instructions to the broker to make trades that can be allocated to another entity or individual.

The auditor identifies the assets that are susceptible to stealing and considers whether there are controls in place to prevent or detect the theft. If controls are inadequate to prevent or detect a material misstatement due to stealing, the auditor plans substantive procedures to detect the misstatement. If the auditor believes that specific identified risks of material misstatement due to stealing are mitigated by controls, the auditor might decide that it is efficient to plan to test those controls. However, at the initial planning stage in the audit, the auditor is concerned with how the risk assessment will influence the audit approach to various financial statement areas and not with the detailed procedures to be applied to particular accounts.

As discussed in Lesson 1, AU-C 240.17–.21 requires specific fraud-related inquiries of management, others within the entity, internal auditors, and those charged with governance or the audit committee. The auditor inquires of management about its understanding of the risks of fraud, programs and controls in place to lessen fraud risks, and whether management knows of any actual fraud or is aware of any alleged fraud in the entity. Similar inquiries are made of others within the entity who the auditor believes may be able to provide useful information (such as operating personnel not directly involved in financial reporting and other employees with various levels of authority or involved in complex or unusual transactions), internal auditors, and those charged with governance.

Immaterial Misstatements Caused by Fraud. AU-C 200.07 observes that "the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements taken as a whole, are detected." AU-C 240.A3 also notes that the auditor is primarily concerned with fraud that causes a material misstatement of the financial statements. If immaterial misstatements arising from fraud are detected, the auditor has responsibilities for evaluating the effect on the audit and communicating these matters to an appropriate level of management and those charged with governance.

There are types of frauds that may not result in the financial statements being materially misstated for any individual period, but may be perceived to be material, especially if the amounts involved accumulate over time. For example, assume that a bookkeeper in a small business embezzles $5,000 per year for several years and hides the fraud by inflating cost of sales each year. That amount is immaterial to each year. After several years, the fraud is detected and the amounts stolen aggregate $30,000, which might be considered material if the financial statements for any individual period were misstated by this amount. Because the financial statements are not materially misstated in any given period, the auditor is not responsible under professional standards for detecting such a fraud. This situation does result in a business risk for the auditor because a client may have the expectation that the auditor will detect fraud, whether or not the financial statements are materially misstated. This perception of the auditor's responsibility goes beyond what is required by professional standards. Informing clients about the auditor's responsibility under professional standards is important. (Auditors are required to communicate to the appropriate level of management if they determine there is evidence that fraud may exist, even if the matter is inconsequential.) Nevertheless, some auditors believe that, as a matter of good business practice and meeting client expectations, auditors would be well-advised to consider whether expanding the scope of audit procedures to respond to risks of defalcation of this type would be worthwhile. Auditing standards do not require that, but business risk is reduced and important client expectations may be satisfied.

The Importance of Exercising Professional Skepticism

AU-C 240.12 observes that throughout the audit, the auditor should exercise professional skepticism and recognize the possibility of a material misstatement due to fraud regardless of any beliefs about honesty and integrity of management and those charged with governance gained from past experience. AU-C 240.13–.14 establishes the following requirements that relate to maintaining professional skepticism during the planning and performance of the audit:

- Unless there is a reason to believe otherwise, accept client records and documents as genuine. Investigate further if conditions indicate a document may not be authentic or its terms have been modified or not disclosed.

- If inconsistent, vague, implausible, or otherwise unsatisfactory responses are made to inquiries of management, those charged with governance, or others, investigate further.

Because the characteristics of fraud include concealment, misrepresentation, falsified documents, and collusion, the need for professional skepticism is especially important when considering the risks of material misstatement due to fraud. When exercising professional skepticism, auditors suspend any belief in management's or the owner/manager's honesty and integrity and approach the audit with a questioning mind. Regardless of past experience with the client, auditors acknowledge and remain open and alert to the possibility that material misstatement due to fraud may exist. All of the information and evidence gathered by the auditor is critically evaluated and an ongoing assessment is made of whether the evidence suggests that the financial statements are materially misstated due to fraud. The auditor is not willing to accept less than persuasive evidence based on a belief that management or key employees are honest.

The Auditor's Fraud Risk Assessment Process

AU-C 240.25 requires auditors to assess identified risks of material misstatement due to fraud. The following fraud risk assessment process is used to identify and respond to fraud risks (as discussed above, however, the process is not necessarily sequential):

a. Hold a discussion among engagement team members to consider the susceptibility of the client's financial statements to material misstatement due to fraud.

b. Make inquiries of management and others within the entity and consider other information obtained to identify risks of material misstatement due to fraud.

c. Evaluate unusual or unexpected relationships identified by analytical procedures.

d. Identify risks that may result in material misstatement of the financial statements due to fraud.

e. Assess the identified risks after taking into account an evaluation of the entity's antifraud programs and internal controls.

f. Respond to the results of the risk assessment.

Auditors gather other information that may be relevant to identifying risks of material misstatement due to fraud while obtaining an understanding of the entity and its environment, its internal control, and its fraud risk factors, and from the performance of preliminary analytical procedures. Other information auditors need to consider in identifying risks of material misstatement due to fraud includes the discussion among engagement team members, information from client acceptance and continuance procedures, the auditor's inherent risk assessment and, if applicable, other engagements performed for the entity.

If the auditor identifies risks of material misstatement due to fraud, the audit response may be overall or specific, and may include substantive procedures or tests of controls. (However, substantive analytical procedures alone are not a sufficient response.) Specific responses are addressed in individual audit programs. Overall responses have an overall effect on how the audit is conducted. Certain overall responses, such as the consideration of staffing and supervision, scrutiny of the selection and application of accounting principles, and incorporating an element of unpredictability in audit procedures, are considered in every audit. In addition, there are certain required responses to address the risk of management override of controls.

Documenting the Fraud Risk Assessment. Although AU-C 240 defines a fraud risk assessment process that results in identifying and documenting risks of material misstatement due to fraud and the auditor's responses to those risks, it does not change the overall audit risk assessment process in AU-C 315. Audit risk at the account balance or transaction class level consists of three components: inherent risk, control risk, and detection risk. AU-C 240 does not add another component to the audit risk model. This is because fraud risks encompass both inherent and control risk attributes. Under the audit approach suggested by this course, the auditor makes separate assessments of inherent and control risk (including the risks of fraud) and uses those assessments to determine the risk of material misstatement. In addition, the auditor considers whether the audit programs are appropriate in light of the assessed risk of material misstatement.

AU-C 240.43, .44, and .46 require the auditor to document evidence that he or she assessed the risks of material misstatement due to fraud. The auditor is required to document the following:

- Engagement team discussion on susceptibility of financial statements to material misstatement due to fraud:
  - Significant decisions reached.
  - How and when it occurred and who participated.
- Identified and assessed risks of material misstatement due to fraud:
  - At the financial statement level.
  - At the assertion level.
- Responses to the assessed risks of material misstatement due to fraud:
  - Overall responses at the financial statement level.
  - Specific responses at the assertion level (nature, timing, and extent of audit procedures and linkage to assessed risks).
  - Results of audit procedures, including those that address risk of management override.
- How the auditor overcame the presumption that improper revenue recognition is a fraud risk, if applicable.

This course discusses a practical approach to fraud risk assessment that addresses the requirements in AU-C 240. Exhibit 3-5 illustrates how that approach accomplishes the requirements outlined above. Practice aids are beyond the scope of this course, but such items are available in *PPC's Guide to Audits of Nonpublic Companies.*

Exhibit 3-5

Practice Aids for Documenting the Fraud Risk Assessment

AU-C 240 Requirements	PPC Approach to Fraud Risk Assessment
Hold a discussion among engagement team members to consider the susceptibility of the client's financial statements to material misstatement due to fraud and to reinforce the importance of professional skepticism. Obtain other information needed to identify risks of material misstatement due to fraud.	**Step 1.** Gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements due to fraud: • Discussion among engagement team members. • Inquiries of management and others. • Considering whether fraud risk factors are present. • Preliminary analytical procedures. • Other procedures.
Identify risks that may result in material misstatement of the financial statements due to fraud.	**Step 2.** Identify risks that could result in material misstatement of the financial statements due to fraud.
Assess the identified risks after taking into account an evaluation of the company's antifraud programs and internal controls.	**Step 3.** Assess the identified risks: • Evaluate programs and controls. • Assess fraud risks.
Respond to the results of the risk assessment.	**Step 4.** Develop appropriate responses to risks of material misstatement of the financial statements due to fraud: • Overall responses. • Specific responses. • Responses to further address the risk of management override of controls.

* * *

Fraud Consulting Services

If clients become aware that employees have committed fraud or suspect that fraud may be taking place, they may attempt to engage the auditor to perform fraud investigation consulting services. Such an engagement can take various forms. Before accepting such engagements for audit clients, auditors need to assess the potential liability associated with their services—particularly if the alleged fraud was not detected during the firm's audit. To avoid the appearance of a conflict of interest, as required by Statement on Standards for Consulting Services No. 1, the fraud investigation services should ordinarily be performed by someone other than the personnel involved in the audit. The firm needs to consider whether it can be objective in the forensic investigation given the self-interest created by its audit responsibilities. The firm also needs to consider consulting legal counsel, and the understanding with the client regarding the performance of these nonattest services ought to be documented.

Additionally, the auditor needs to determine whether litigation is possible or whether the client's interest is limited to submitting a fidelity insurance claim. In considering whether to accept the engagement, the auditor needs to evaluate whether the firm has the forensic investigation skills that will be necessary and the implications for audit independence. If litigation is at all a possibility, legal counsel ought to be in charge of the investigation under the overall supervision of the client's board of directors to preserve attorney-client privilege. If there is a possibility that the firm personnel working on the engagement would be expected to testify as expert witnesses, independence is normally impaired and the engagement ought to be declined. Also, there is a possibility that the engagement will expand to include prior periods, the adequacy of prior audits might be implicated and it would be advisable for the firm to decline the engagement.

THE AUDITOR'S CONSIDERATION OF LAWS AND REGULATIONS

AU-C 250.06 distinguishes the auditor's responsibilities regarding compliance with laws and regulations between the following two categories of laws and regulations:

a. The provisions of those laws and regulations generally recognized to have a *direct* effect on the determination of material amounts and disclosures in the financial statements. Examples are accruals and expenses affected by tax laws, or revenue accrued under government contracts.

b. The provisions of other laws and regulations that have an *indirect* effect on the determination of the amounts and disclosures in the financial statements. However, compliance with those other laws and regulations may be fundamental to the operating aspects of the entity, fundamental to an entity's ability to continue as a going concern, or necessary for the entity to avoid material penalties. Examples include compliance with an entity's operating license and with laws or regulations related to occupational safety and health, food and drug administrations, etc.

The auditor's objective when considering laws and regulations is to obtain sufficient, appropriate evidence for material amounts and disclosures in the financial statements that are *directly* determined by the provisions of laws and regulations. In addition, the auditor is required to perform specific procedures that could identify potential noncompliance with laws and regulations that may have a material *indirect* effect on the financial statements. This section discusses the auditor's responsibility when planning and performing the audit. A discussion of the auditor's responsibility if noncompliance with laws or regulations is identified or suspected during the audit is beyond the scope of this course, but more information on the subject is available in *PPC's Guide to Audits of Nonpublic Companies.*

Responsibilities When Planning the Audit

During the planning and risk assessment stage of the audit, AU-C 250.12 states that when obtaining an understanding of the entity and its environment, the auditor should obtain a general understanding of—

- The laws and regulations to which an entity is subject (the legal and regulatory framework) and the industry or sector in which the entity operates.

- How the entity complies with those laws and regulations.

AU-C 250.A8 provides the following examples of procedures the auditor might use to obtain a general understanding of the legal and regulatory framework and how the entity complies with that framework:

- Use the existing understanding of the entity's industry and regulatory and other external factors from the current and prior audits.

- Update the understanding of those laws and regulations that directly determine reported amounts and disclosures, such as tax and pension laws and regulations.

- Inquire of management about other laws and regulations expected to have a fundamental effect on the operations of the entity. (For example, depending on the nature of the business or industry, those laws and regulations may include environmental regulations, occupational safety and health requirements, or anti-trust laws.)

- Inquire of management about the policies and procedures adopted to prevent noncompliance (or help ensure compliance) and identify, evaluate, and account for litigation claims.

- Inquire of management about whether directives have been issued or periodic representations are obtained relating to compliance.

- Consider knowledge from prior audits of any history of noncompliance.

In planning and performing the audit, the auditor takes into account the knowledge of the applicable legal and regulatory framework obtained as part of obtaining an understanding of the entity and its environment.

A number of audit procedures related to obtaining an understanding of the legal and regulatory framework involve inquiries of management. The responses to these inquiries should be documented.

Responsibilities When Performing the Audit

Provisions with a Direct Effect. AU-C 250.13 explains that the auditor should obtain sufficient appropriate evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of laws and regulations generally recognized to have a direct effect on their determination. AU-C 250.A10 indicates that the auditor's responsibility for detecting misstatements resulting from violations of laws and regulations having a direct and material effect on the determination of financial statement amounts and disclosures is the same as that for misstatements caused by errors and fraud. For example, the accrual or recognition of expenses for income tax or pension costs is tested using the audit programs for income taxes or accounts payable and other liabilities in this course.

Provisions of Other Laws and Regulations. Noncompliance with the provisions of other laws and regulations may result in fines, litigation, or other consequences for the entity, which may need to be accrued or disclosed in the financial statements, but do not have a direct effect on determining amounts in the financial statements. The auditor is required to inquire of management and, when appropriate, those charged with governance about whether the entity is in compliance with other laws and regulations. In addition to inquiries of management about whether the entity is in compliance with other laws and regulations, AU-C 250.14 also requires the auditor to inspect any correspondence with the relevant licensing or regulatory authorities.

PLANNING AN AUDIT TIME ESTIMATE

Authoritative literature does not require the preparation of a time estimate or the documentation of the actual time spent in performing an audit. However, common sense suggests that an auditor is more likely to be efficient and effective working under a time budget. Also, as a minimum, an auditor ordinarily needs to have some estimate of audit time to arrive at a fee estimate. Keeping track of the time spent as the audit progresses is important for billing the client, assessing whether adjustments are necessary to stay within the budget for the engagement, or proposing additional fees to the client.

Methods used in practice to budget and control time range from elaborate systems that budget time by each program step to a single total time estimate for the entire audit. Neither extreme is likely to be effective. This course suggests using a system that accounts for time by each major audit program area, i.e., total time for cash, total time for accounts receivable and revenue, etc. Other major engagement processes outside of audit program areas also need to be considered such as planning activities, review and supervision, assistance with financial statements, and drafting reports. This provides enough detail to highlight major areas of time commitment, monitor work-in-progress, and arrive at a reasonable fee estimate. Using this budget technique, the auditor need not post time to the audit program; instead, time is posted to a summary schedule by major program area that is normally filed with the general or administrative workpapers.

It needs to be emphasized that the final audit time estimate ought to be completed after the planning stage, i.e., after the audit programs are developed and the auditor has a general feel for the extent of testing. This may not coincide with the date that the auditor presents a fee estimate to a client, especially to a prospective client. However, avoid the temptation to develop the audit time estimate based solely on the fee estimate, especially if it is an extremely competitive fee estimate that is not representative of standard billing rates times realistic total audit hours.

Managing Client Assistance to Improve Efficiency

Clients can have a significant effect on how efficiently an audit is completed. It is not unusual for the explanation of audit budget overages to be "the client did not prepare requested schedules" or "requested schedules were prepared incorrectly by the client." In some cases, audit inefficiencies result from the client not being available to answer the auditor's questions or to retrieve needed information once fieldwork has begun. While it is often the case that some audit budget overages caused by the client are beyond the auditor's control, in many cases the auditor can improve the efficiency of the audit by effectively managing client assistance.

Schedules Prepared by the Client. In order to save audit fees, most clients are willing to prepare needed schedules for the auditor. In fact, to be efficient, the auditor needs to try to get the client to prepare as many of the necessary schedules as possible. However, many inefficiencies can result from the process of obtaining schedules from the client. For example, schedules may not be prepared by the time the auditor needs them so that the auditor ends up spending time preparing the schedules and exceeding the budget for the area. Or in other cases, the schedules are prepared on a timely basis, but incorrectly; so the auditor spends additional time revising the schedules to make them useable. The following paragraphs discuss steps the auditor can take to minimize the inefficiencies often experienced when requesting schedules from the client.

List Everything Needed. When preparing a list of schedules to be prepared by the client ("the PBC list"), make sure that the list is complete. Inefficiencies result from asking for more information after fieldwork has begun because the auditor often needs to wait for the client to prepare the schedule. If a complete PBC list is provided to the client before fieldwork begins, the client is more likely to have the schedules completed before the audit starts. As a result, client personnel have more time to answer the auditor's questions if they are not busy trying to complete additional schedules. To make sure the PBC list is complete, the auditor needs to review it carefully (and avoid just changing the dates on the prior year's PBC list) before sending it to the client. The interim general ledger or trial balance requested during the planning process can be used to identify new accounts for which schedules may be needed.

Make Sure the Client Understands What Information Is Being Requested. When making requests for information from the client, the auditor needs to be specific about what is needed. For example, avoid making requests such as "provide an analysis of activity in the deferred revenue account." The client can be given an example of the format in which the information ought to be provided. If requesting a spreadsheet or another type of schedule, efficiencies may be gained by providing the client with an electronic template. As a result, the auditor will receive the information in the requested format. The client can slot in the requested information and the auditor can save time testing the mechanical accuracy of the schedule by reviewing the spreadsheet formulas. In any case, the auditor needs to go over the PBC list in detail with the client to ensure that the client understands what information is being requested.

Do Not Ask for Unneeded Information. The auditor ought not spend much (if any) time on insignificant accounts. Therefore, review the PBC list to make sure the client is not being asked to prepare schedules for insignificant accounts or those that can be tested analytically. By eliminating the unnecessary schedules, the client will have more time to focus on the schedules for the important areas.

Prioritize Requests for Information. One way to improve audit efficiency is for the auditor to work on the riskier, more complex areas first. As a result, if the auditor identifies problems in the complex areas, the client has more time to correct or research the problems. Efficiency can be improved because the auditor can work on other areas while the client is correcting or researching the problems in the complex areas. To facilitate this approach, request that the client prepare the schedules for the more complicated areas first.

Stagger Due Dates for Requested Information. Ideally, the client would have all requested schedules prepared when fieldwork begins. However, because there may be a tight deadline between year end and the due date of the auditor's report, it may not be feasible for the client to have all information prepared before the beginning of fieldwork. If this is the case, the auditor needs to be realistic when setting the due dates for requested information and not ask for everything to be prepared at once. As discussed above, information for the critical areas ought to be requested first.

Provide Adequate Notice. Although this seems obvious, many auditors are inefficient because they do not provide the client with enough time to prepare for the audit before fieldwork begins. Early preparation of the PBC list is an important step in the planning process and is not a difficult task because the auditor generally spends time in up-front planning before fieldwork begins. The auditor can ask the client how much lead time is needed to adequately prepare for the audit.

Work with the Client. In many cases, the auditor can use the client's existing internal reports to achieve the same objectives as by using a schedule prepared solely for the audit. The auditor needs to work with the client to identify reports or schedules already being prepared by client personnel before adding additional schedules to the client's workload. However, if the auditor will spend time reworking the data to be in a useable format, the auditor needs to attempt to get the client to do this task.

Return Incorrect Schedules to the Client. If the client provides schedules that are prepared incorrectly, return them to the client for corrections. Staff auditors can spend many hours trying to correct the schedules when the client may be able to obtain the correct information much more efficiently. If the client does not have the time to revise the schedules, the auditor can discuss the resulting additional audit fees with the client before the auditor incurs the additional time to correct the schedules.

Keep in Touch with the Client. Before the beginning of fieldwork, it is important for the auditor to keep in contact with the client to determine whether the client will have the necessary schedules prepared before fieldwork begins. In order to be effective, this communication requires more than a phone call the day before fieldwork begins to see if the client is ready. Such communication ought to be made well enough in advance so that the auditor can reschedule fieldwork if necessary. Many auditors use email to keep in contact with the client prior to fieldwork to check the status of schedule preparation and to answer questions the client may have. If the client is preparing spreadsheets for the auditor, email can be used to transfer the file to the auditor if the client has questions about how the schedule needs to be prepared.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. When auditing Harrington Enterprises, Nancy discovers an absence of controls that could allow employees to commit fraud. This is an example of what type of condition?

    a. Incentive/pressure.

    b. Opportunity.

    c. Attitude/rationalization.

    d. Misappropriation of assets.

27. Doing which of the following will help an auditor effectively manage client assistance for a more efficient audit?

    a. Ask for all possible information so the client can get it at one time.

    b. Send requests for all information at once so it is in one place and easy to reference.

    c. Give the client one due date so there is no confusion about when schedules must be prepared.

    d. Return incorrect schedules to the client to be corrected instead of auditors correcting schedules themselves.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. When auditing Harrington Enterprises, Nancy discovers an absence of controls that could allow employees to commit fraud. This is an example of what type of condition? **(Page 263)**

    a. Incentive/pressure. [This answer is incorrect. Three conditions are usually present when fraud occurs. One such condition is *incentive/pressure*, which is when management or other employees have a reason to commit fraud. This condition is different from the one exemplified in the scenario above.]

    b. Opportunity. [This answer is correct. Circumstances, such as ineffective controls, the absence of controls, or the ability to override controls, that enable management or other employees to commit fraud is considered the *opportunity* to commit fraud and is one of the three conditions that are generally present when fraud occurs.]

    c. Attitude/rationalization. [This answer is incorrect. *Attitude/rationalization* is when management or other employees are able to justify the acceptability of committing fraud. This is one of the three conditions that are generally present when fraud exists; however, it is not the one illustrated at Harrington Enterprises in this scenario.]

    d. Misappropriation of assets. [This answer is incorrect. There are two types of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit: (1) misstatements resulting from fraudulent financial reporting and (2) misstatements resulting from misappropriation of assets. It is not obvious from the scenario above which type of fraud Nancy might discover at Harrington Enterprises. Additionally, misappropriation of the assets is a type of fraud, not a condition present when fraud exists. Therefore, there is a better answer to this question.]

27. Doing which of the following will help an auditor effectively manage client assistance for a more efficient audit? **(Page 272)**

    a. Ask for all possible information so the client can get it at one time. [This answer is incorrect. It is better if auditors do not ask for unneeded information. The auditor ought not to spend much (if any) time on insignificant accounts. By eliminating unnecessary schedules, the client will have more time to focus on the schedules for the important areas.]

    b. Send requests for all information at once so it is in one place and easy to reference. [This answer is incorrect. One way to improve audit efficiency is for the auditor to work on the riskier, more complex areas first. To facilitate this approach, auditors should request that the client prepare the schedules for more complicated areas first.]

    c. Give the client one due date so there is no confusion about when schedules must be prepared. [This answer is incorrect. Because there may be a tight deadline between year end and the due date of the auditor's report, it may not be feasible for the client to have all information prepared before the beginning of fieldwork. If this is the case, the auditor needs to be realistic when setting the due dates for requested information and not ask for everything to be prepared at once.]

    d. Return incorrect schedules to the client to be corrected instead of auditors correcting schedules themselves. [This answer is correct. If the client provides schedules that are prepared incorrectly, return them to the client for corrections. Staff accountants can spend many hours trying to correct the schedules when the client may be able to obtain the correct information much more efficiently.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 2—Risk Assessment Procedures and Planning (ASBTG182)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.tr.com**/**ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $95 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($95 for email or fax; $105 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
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     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($95 for answer sheets sent by email or fax; $105 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $271 (a 5% discount on all three courses). If you complete four courses, the price for

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EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 2—Risk Assessment Procedures and Planning (ASBTG182)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. The auditor's high-level approach for achieving audit objectives is called what?

    a. Audit plan.

    b. Audit program.

    c. Audit strategy.

    d. Risk assessment.

2. What is the focus of risk assessment procedures in an audit engagement?

    a. Gathering and evaluating information.

    b. Testing the client's controls.

    c. Serving as substantive procedures.

    d. Providing sufficient and appropriate audit evidence for the audit opinion.

3. When does an auditor perform risk assessment procedures?

    a. When deciding whether to accept the engagement.

    b. When obtaining an understanding of the entity and its environment.

    c. When performing substantive procedures to gain additional information.

    d. When finalizing the auditor's opinion on the financial statements.

4. Jane is engaged to audit a small, nonpublic company. As part of her engagement, she plans to make inquiries about how complex or unusual transactions are initiated, authorized, processed, and recorded. To whom should Jane address such inquiries?

    a. In-house legal counsel.

    b. Financial reporting personnel.

    c. Information technology (IT) personnel.

    d. Third parties outside the company.

5. When performing analytical procedures for planning purposes, an auditor should do what?

   a. Create a precise quantification of expected relationships.

   b. Use the same procedures for all audit clients.

   c. Make mechanical computations and comparisons.

   d. Bring creativity and insight to the procedures.

6. Typically, observation and inspection procedures are used to do what?

   a. Corroborate the results of inquiries made to management or others.

   b. Meet professional requirements for performing analytical procedures.

   c. Identify declining trends in operations or significantly reduced liquidity.

   d. Encourage brainstorming between engagement team members.

7. As part of his observation and inspection procedures in the audit of a nonprofit organization, Dustin reads the minutes from the directors' meetings. What potential risk might Dustin discover by performing this procedure?

   a. Increased risk related to warranty obligations due to returned products in the client's inventory.

   b. Increased risk related to unrecognized sales discounts and rebates after a shift in marking and sales strategies.

   c. Increased risk of impairment due to significant damage found related to equipment that is uninsured by the client.

   d. Increase in overall risk due to weakness in the control environment because all of management's decisions are rubber-stamped.

8. Engagement team members must do which of the following during the engagement team discussion?

   a. Limit talking to engagement partners with the most experience.

   b. Use professional skepticism throughout the discussion.

   c. Utilize a memo format to save money on travel expenses.

   d. Hold fast to beliefs about the client's integrity due to past experience.

9. When should the engagement team discussion occur?

   a. Prior to the audit engagement being accepted by the firm.

   b. After the engagement partner has preliminary planning discussions with the client.

   c. After analytical procedures have been performed and an understanding of the entity has been obtained.

   d. After audit work is complete and the engagement team must express an opinion on the financial statements.

10. Obtaining an understanding of the audit client and its environment does what?

    a. Increases the length of time the audit will take by making auditors do more work.

    b. Allows the auditors to know who within client management can verify the sufficiency of audit evidence.

    c. Eliminates the need for auditors to rely on planning materiality or other related judgments.

    d. Allows the auditors to determine if risks have resulted in material misstatement.

11. Gathering knowledge about an entity's revenue sources, key customers, products or services, markets, and operations helps an auditor obtain an understanding of which of the following?

    a. The nature of the entity.

    b. The entity's industry and other external factors.

    c. The entity's objectives, strategies, and related risks.

    d. How the entity selects and applies its accounting policies.

12. An auditor's inquiries about a business's strategies and objectives to identify the related business risks should be made to whom?

    a. Upper management.

    b. In-house legal counsel.

    c. Internal audit personnel.

    d. Rank and file employees.

13. Key performance indicators (KPI), trends, key ratios, forecasts, and budgets can be used to obtain an understanding of what?

    a. What business risks the entity will face due to its objectives and strategies.

    b. How management measures and reviews the entity's financial performance.

    c. How management selects and applies its accounting policies.

    d. Whether risk factors exist that indicate incentive or pressure to commit fraud.

14. If an auditor determines that there is a significant risk in management's selection of accounting principles or that policies are being applied inappropriately, how should the issue be addressed?

    a. Determining whether the entity's regulatory compliance is affected.

    b. Reacting as if the existence of a fraud risk factor means fraud exists.

    c. Performing fewer audit procedures.

    d. Assigning more experienced personnel to the engagement.

15. An overall response to the risk of material misstatement due to fraud is considered when?

    a. While identifying business risks.

    b. During the performance of risk assessment procedures.

    c. While establishing the overall audit strategy.

    d. While developing the detailed audit plan.

16. What are the five components of internal control as listed in COSO's *Internal Control—Integrated Framework* (the COSO framework)?

    a. Control activities, control environment, fraud prevention, monitoring, and risk assessment.

    b. Control activities, fraud prevention, information and communication, risk assessment, and substantive procedures.

    c. Control activities, control environment, information and communication, monitoring, and risk assessment.

    d. Control environment, information and communication, monitoring, risk assessment, and substantive procedures.

17. Which of the following statements best describes the auditor's understanding of internal control?

    a. It is more comprehensive than the understanding of other aspects of the entity and its environment.

    b. It takes less time than obtaining an understanding of other aspects of the entity and its environment.

    c. It takes less time and effort to obtain an understanding of internal control in an initial engagement than it does in later years.

    d. The auditor is required to obtain an understanding of all of the controls in use by his or her client.

18. Controls that address the risk of fraud most frequently relate to which components of quality control?

    a. Control environment and control activities.

    b. Control activities and monitoring.

    c. Control environment and information and communication.

    d. Control activities and risk assessment.

19. What type of effect does IT have on internal control?

    a. Typically, IT has little effect because it is a separate department.

    b. IT factors into the understanding of internal control, but it is a lesser consideration.

    c. IT can have an extensive effect due to the nature and complexity of the system.

    d. It is possible to obtain an understanding of internal control without considering IT.

20. Which of the following statements best describes an aspect of the approach to obtaining an understanding of internal control put forth in this course?

    a. Because auditors can default to a control risk of maximum, obtaining this understanding is simple.

    b. An understanding of all five elements of internal control is important for large clients, but not necessary for smaller ones.

    c. Obtaining information about activity-level controls first helps auditors obtain the necessary knowledge about entity-level controls.

    d. Performing scoping activities allows auditors to use a top-down approach to obtain the understanding more efficiently.

21. Where should the auditor start when obtaining an understanding of entity-level controls?

    a. The information system and related control activities.

    b. The control environment and other entity-level controls.

    c. Activity-level controls related to the financial statements.

    d. The proper starting point depends on the entity itself and differs by engagement.

22. Narratives, memos, questionnaires, checklists, and flowcharts can all be used for what purpose?

    a. To document the auditor's understanding of internal control.

    b. To distinguish between control objectives and control principles.

    c. To indicate how the entity utilizes proper segregation of duties.

    d. To identify an entity's significant transaction classes.

23. What states the purpose of a control in relation to what could go wrong in the financial statements?

    a. Control objective.

    b. Control principle.

    c. Key control.

    d. Top-down approach.

24. Why are entity-level controls important?

    a. They are heavily influenced by the design and effectiveness of activity-level controls.

    b. The auditor gains an understanding of them based on information from the activity-level controls.

    c. They are directly related to how the client's transactions are processed and reported.

    d. They often have a pervasive effect on the client's entire system of internal control.

25. What component of internal control is considered the foundation for all the others (e.g., by providing structure and discipline)?

    a. Control environment.

    b. Information and communication.

    c. Monitoring.

    d. Risk assessment.

26. Which of the following would be most likely to affect an entity's risk assessment?

    a. Retaining experienced personnel.

    b. Slow or moderate growth.

    c. Meeting existing accounting standards.

    d. Changes in the entity's operations.

27. Typically, for a small to midsize nonpublic audit client, the auditor's entity-level understanding of the client's information process will be what?

    a. Complicated.

    b. Time consuming.

    c. Not complex.

    d. Unimportant.

28. Effective monitoring must do which of the following?

    a. Take place annually.

    b. Ensure controls are modified as changes occur.

    c. Be made up of separate evaluations.

    d. Rely on the audit to determine what areas to check.

29. General IT controls would include all of the following **except**:

    a. Those related to the data center and network operations.

    b. Those related to how people gain access to programs and data.

    c. Those related to IT strategic planning.

    d. Those that provide internal control for an application.

30. Which of the following is considered an activity-level control instead of an entity-level control?

    a. Control activities.

    b. Control environment.

    c. Monitoring.

    d. Risk assessment.

31. When obtaining an understanding of an entity's internal control, where to auditors often spend the most time?

    a. Control activities.

    b. The financial reporting system.

    c. The IT environment.

    d. The top-down approach for information.

32. When obtaining an understanding of her audit client's financial system, Maxine chooses transactions from the major transaction classes and takes them from initial creation of the source document to the final posting in the general ledger and inclusion in her client's financial statements. What type of procedure has Maxine performed?

    a. A control activity.

    b. A general IT control.

    c. A monitoring activity.

    d. A walkthrough.

33. How often might an auditor perform walkthroughs?

    a. Twice per reporting period.

    b. Annually.

    c. Biannually.

    d. Only once, as it will be considered evidence from a prior year.

34. What do the auditing standards require in relation to the auditor's understanding of control activities?

    a. They are required to understand all control activities for all transactions, account balances, and financial statement disclosures.

    b. They are required to understand all control activities related to every assertion.

    c. They are required to understand all control activities necessary to assess risk of material misstatement at the relevant assertion level and design and perform further audit procedures.

    d. They are not required by the auditing standards to gain any specific understanding; the understanding obtained by auditors related to control activities is a matter of professional judgment.

35. What term is used for the auditor's preliminary judgment of materiality at the financial statement level?

    a. Evaluation materiality.

    b. Performance materiality.

    c. Planning materiality.

    d. Tolerable misstatement.

36. According to AU-C 320.04, a misstatement or omission is considered material if it does what?

    a. Is mentioned or disclosed in the entity's financial statements.

    b. Is mentioned in the auditor's report.

    c. Is calculated on a quantitative basis.

    d. Influences the economic decisions of financial statement users.

37. At the beginning of her audit engagement, Joyce determines planning materiality using interim financial information. After she gets her client's final financial information, she determines that her planning materiality amount was too small. How might this affect her audit engagement?

    a. The scope of her engagement may not be sufficient.

    b. Joyce will not have done enough audit work.

    c. Joyce will need to consider revising her materiality level.

    d. Once set, materiality levels cannot change, so Joyce must use the amount she has.

38. Tolerable misstatement is—

    a. the application of performance materiality to an audit sampling procedure.

    b. the same amount or larger than performance materiality.

    c. an extension of the concept of planning and evaluation materiality.

    d. materiality at the account balance or transaction level.

39. These potential audit clients are all small to medium-sized nonpublic companies. Based on the scenario below, which one would have the highest performance materiality?

    a. Mac-2 has a large number of locations within a single account.

    b. Whammy Inc. is expected to have few misstatements.

    c. The management of Baker's Dozen is resistant to change.

    d. Paisley Products has a large number of accounts that require estimation.

40. What is the nonposting threshold?

    a. The amount of accumulated misstatements determined to be clearly trivial.

    b. The identifying factor that requires analytical procedures instead of tests of details.

    c. The amount of risk that identifies with the control environment instead of the transaction level.

    d. The amount of factual misstatements that have been detected in an audit engagement.

41. Which of the following should an auditor keep in mind when auditing a small business?

    a. Its segregation of duties is likely to be adequate.

    b. Operational control is concentrated in few individuals.

    c. Tests of controls will be more useful than substantive procedures.

    d. A large amount of time will be needed to document control activities.

42. The management of Wheeler Inc. overstates its revenue so they will receive higher bonuses. This is an example of which of the following? (Choose the most specific term that apples.)

    a. Fraud.

    b. Fraudulent financial reporting.

    c. Immaterial misstatements.

    d. Misappropriation of assets.

43. Auditors will do which of the following when exercising professional skepticism?

    a. Treat client records as inauthentic unless proven otherwise.

    b. Investigate any vague or implausible inquiry responses further.

    c. Believe that the client is honest and trustworthy unless contrary evidence is found.

    d. To save time, assume that evidence about the client has not changed from last year.

44. There are two categories of laws and regulations that may affect an audit client—direct and indirect. The laws and regulations that fall into the direct category have a direct affect on what?

    a. Material amounts and disclosures in the client's financial statements.

    b. How the entity operates and conducts its business.

    c. The entity's ability to continue as a going concern.

    d. The entity's susceptibility to fines or litigation.

45. Audit time estimates—

    a. are required by authoritative literature.

    b. are created using elaborate and cumbersome systems.

    c. make audits less efficient and effective.

    d. help auditors estimate fees and facilitate billing.

GLOSSARY

Activity-level controls: The *components of internal control* that fall into this category are the financial reporting system and control activities.

Audit plan: More detailed than the *audit strategy*, this documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. It is also called an *audit program*.

Audit risk: The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

Audit strategy: The auditor's operational approach to achieving the objectives of the audit. It is a high-level determination of the audit approach that includes identification of overall risks, overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls.

Brainstorming: An open exchange of ideas, such as the one required between key members of the audit team.

Clearly trivial misstatements: This amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered. It is also called the nonposting threshold.

Components of internal control: As outlined in COSO's *Internal Control—Integrated Framework*, these components are (1) control environment, (2) risk assessment, (3) information and communication, (4) monitoring, and (5) control activities.

Control objective: This states the purpose of a control (or controls) in relation to risks and what might go wrong in the financial statements. They are often used in connection with controls related to account balance, transaction class, disclosures, and general IT controls.

Control principles: Adapted from COSO's 2013 updated *Internal Control—Integrated Framework*, these represent the fundamental concepts associated with each component of internal control. They are concise statements that compress important internal control ideas and concepts into a few words and that give direction to implementation. They are often used for *entity-level controls*, such as control environment and monitoring.

Cooking the books: Fraudulent financial reporting. Such reporting is one way (in addition to stealing) that can lead to material misstatement of the financial statements due to fraud.

Cybersecurity: This encompasses all IT-related controls in an entity's IT platform that guard against unauthorized access. It relates to data, systems that process that financial-statement-related data, and controls over those systems that could affect the financial statements and the safeguarding of assets in a material way.

Cybersecurity risk: This is the risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

Direction of the engagement team: When the engagement partner informs the engagement team about certain matters, such as their responsibilities, objectives of the work to be performed, the nature of the entity's business, risk-related issues, problems that could arise, and the detailed audit approach.

Entity-level controls: These are *components of internal control* that typically have a pervasive effect on the entity's system of internal control and can, therefore, potentially influence the design and operating effectiveness of other controls. They are also known as company-level controls. They include the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring. The IT environment and general IT controls are also included in this group.

Financial reporting system: It includes the accounting system and encompasses the procedures and records established to initiate, authorize, process, correct, transfer to the general ledger, and report the entity's transactions. It also includes accountability over assets, liabilities, and equity.

Key controls: Controls that are the most important in achieving a particular *control objective* and will be focused on by the auditor. Their failure could materially affect the relevant assertion, but such failure may not be detected in a timely manner by other controls.

Misstatements resulting from fraudulent financial reporting: These are intentional misstatements, or omissions, of amounts or disclosures from the financial statements with the intent of deceiving financial statement users. Such misstatements are also known as *cooking the books*.

Misstatements resulting from misappropriation of the assets: These involve theft of the entity's assets that results in the financial statements not being presented, in all material respects, in conformity with GAAP. Such misstatements are also known as *defalcation*, *embezzlement*, *theft*, and *employee fraud*.

Planning materiality: The preliminary judgment about materiality at the financial statement level.

Professional skepticism: When an auditor has a questioning mind, is alert to conditions that could indicate possible misstatement due to fraud or error, and makes a critical assessment of the audit evidence.

Risk assessment procedures: Audit procedures performed to obtain an understanding of the entity and its environment, including internal control. Information obtained while performing such procedures is used to support the auditor's assessment of the risk of material misstatement.

Risk assessment process: This involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on the understanding.

Significant risks: All fraud risks are classified thusly. Additionally, these often relate to nonroutine transactions, for example, with related parties, and judgmental matters, such as estimates. Revenue recognition issues can also pose such risks.

Significant transaction classes: Classes of transactions in the entity's operations that are significant to the financial statements, generally because of the volume or risk characteristics of transactions processed.

Tolerable misstatement: The application of performance materiality to a particular audit sampling procedure. It may be the same amount or an amount that is smaller than performance materiality. It is at the test or procedure level, not the account balance or transaction level.

Top-down approach: This approach to understanding internal control begins at the financial statement level and works down to the individual activity control level.

Walkthrough: A method for obtaining an understanding of the design and implementation of the *financial reporting system* for a *significant transaction class* in which the auditor traces a transaction through the various processing steps and related controls form initiation to inclusion in the general ledger and financial statements. Also known as a cradle-to-grave procedure.

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COMPANION TO PPC'S AUDITS OF NONPUBLIC COMPANIES

COURSE 3

CONCLUDING THE AUDIT (ASBTG183)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an overview to the procedures and communication required by an auditor when concluding the audit of a nonpublic company. Lesson 1 reviews the authoritative literature that provides auditors guidance in concluding an audit. This lesson also addresses commitments, contingencies and liabilities, lawyer's letter, written representations, subsequent events review, and related-party transactions. Finally, the lesson provides guidance on evaluating an entity as a going concern, reevaluating the risk of material misstatement at the conclusion of the audit, and the purpose of analytical procedures at the final review stage. Lesson 2 covers the documentation required when completing an audit and the requirements for preparing and drafting an auditor's report. In addition, Lesson 2 covers the necessary communication between the auditor, management of the client, and those charged with governance.

PUBLICATION/REVISION DATE: March 2018

RECOMMENDED FOR: Users of *PPC's Guide to Audits of Nonpublic Companies*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **March 31, 2019**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Procedures and Considerations for an Auditor When Concluding an Audit

Completion of this lesson will enable you to:

- Identify the authoritative literature related to concluding an audit of a nonpublic company and how to address commitments, contingencies, and liabilities within the financial statements.
- Recognize the audit procedures related to lawyer's letters, management representation letters, subsequent events review, and related parties in the audit of a nonpublic company.

- Determine the considerations for an entity to be evaluated as a going concern, the disclosures and audit procedures required for risks and uncertainties, and evaluating accounting estimates and fair value.
- Identify the auditor procedures to reevaluate the risk of material misstatement at the conclusion of the audit, identify the purpose of analytical procedures in the final review stage, and discuss the types of engagement reviews.

Lesson 2—Preparing and Drafting an Auditor's Report and the Required Communication with the Client

Completion of this lesson will enable you to:

- Identify the categories for the evaluation and summarization of the misstatements discovered in fieldwork and the documentation the auditor should clarify.
- Determine the auditor's obligations in relation to drafting the financial statements and preparing the auditor's report.

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Lesson 1: Procedures and Considerations for an Auditor When Concluding an Audit

INTRODUCTION

In addition to the audit procedures for specific financial statement components, e.g., cash, accounts receivable, etc., some other procedures are necessary that are more general in nature. The procedures discussed in this lesson are as follows:

a. Procedures to search for *commitments and contingencies*, including obtaining *lawyers' letters*.

b. Obtaining written representations from management in a *management representation letter*.

c. Procedures to search for *subsequent events* that occur after the balance sheet date, but that should be adjusted for or disclosed in the financial statements.

d. Procedures to identify and evaluate the disclosure of *related party transactions*. (Some of these procedures are applied earlier in the engagement, as explained later in this course.)

e. Evaluation of whether there is a substantial doubt about the entity's ability to continue as a *going concern* for a reasonable period of time.

f. Procedures to identify and evaluate the measurement and disclosure of *risks and uncertainties*, *estimates*, and *fair value*.

g. Applying *analytical procedures* as an overall review of financial information.

After applying audit procedures to specific financial statement components and completing the general procedures described above, an auditor should summarize and evaluate the overall results of audit procedures, reach a conclusion on the form of opinion on financial statements, and communicate that opinion and other significant matters in written and oral reports. The auditor is also subject to certain requirements for workpaper finalization and retention. In addition, if the auditor discovers certain matters subsequent to the date of the report, professional standards outline certain procedures that should be performed. These audit requirements are also discussed in this course, particularly as they relate to an audit of a nonpublic company.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the authoritative literature related to concluding an audit of a nonpublic company and how to address commitments, contingencies, and liabilities within the financial statements.
- Recognize the audit procedures related to lawyer's letters, management representation letters, subsequent events review, and related parties in the audit of a nonpublic company.
- Determine the considerations for an entity to be evaluated as a going concern, the disclosures and audit procedures required for risks and uncertainties, and evaluating accounting estimates and fair value.
- Identify the auditor procedures to reevaluate the risk of material misstatement at the conclusion of the audit, identify the purpose of analytical procedures in the final review stage, and discuss the types of engagement reviews.

Authoritative Literature

The authoritative pronouncements that establish requirements, or that provide suggestions that most directly affect the general procedures, include the following:

a. AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, identifies the procedures to search for contingencies and establishes requirements for obtaining information from a client's lawyers.

b. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides guidance and establishes standards on auditing accounting estimates, including fair value accounting estimates and disclosures contained in financial statements.

c. AU-C 550, *Related Parties*, addresses the auditor's responsibilities relating to related party relationships and transactions.

d. AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, describes the audit procedures that should be used to identify subsequent events that have a material effect on the financial statements. The accounting guidance for the financial statements of nongovernmental entities is contained in FASB ASC 855, *Subsequent Events*.

e. AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, gives guidance on the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

f. AU-C 580, *Written Representations*, requires that the auditor obtain certain representations from management.

The authoritative pronouncements that establish requirements or that provide suggestions that most directly affect the aspects of concluding the audit are as follows:

a. Review, summarization, and evaluation:

(1) AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, provides requirements and application and other explanatory material to the auditor and engagement partner as they relate to each element of quality control during the performance of an audit of financial statements.

(2) AU-C 230, *Audit Documentation*, requires the auditor to document significant findings or issues, the actions taken to address them (and the evidence obtained), and the basis for the auditor's conclusions. In addition, AU-C 230 establishes requirements for documenting the auditor's review and finalizing and retaining audit workpapers.

(3) AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud. In addition, AU-C 240 includes requirements for the evaluation of audit findings for indication of possible fraud and for communications with client management.

(4) AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements.

(5) AU-C 300, *Planning an Audit*, establishes broad requirements for review of the work of assistants.

(6) AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires the auditor to evaluate the sufficiency and appropriateness of audit evidence obtained.

(7) AU-C 450, *Evaluation of Misstatements Identified During the Audit*, establishes requirements for the evaluation and communication of audit findings, including the analysis and aggregation of misstatements and documentation of the auditor's conclusion.

(8) AU-C 520, *Analytical Procedures*, requires the use of analytical procedures in the review stage of all audits.

(9) Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (QC 10) establishes several requirements for policies and procedures related to concluding the audit, including matters related to review of workpapers and consultation on technical issues.

b. Required communications:

(1) AU-C 260, *The Auditor's Communication with Those Charged with Governance*, requires communication of certain matters to those charged with governance in an audit of financial statements.

(2) AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, requires written communication of significant deficiencies and material weaknesses to management and those charged with governance.

c. Audit reports:

(1) AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, specifies the auditor's responsibility to form an opinion on the financial statements and the content of the auditor's reports.

(2) AU-C 708, *Consistency of Financial Statements*, requires the auditor to evaluate the consistency of financial statements between periods.

d. Workpaper finalization and retention:

(1) AU-C 230, *Audit Documentation*, sets forth requirements on the time frame for the final assembly and completion of the audit file, as well as guidance on the retention of workpapers.

e. Subsequent discovery of matters after the date of the auditor's report:

(1) AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, provides guidance when auditors subsequently become aware of facts that existed at the date of the report that might have caused them to believe information supplied by the entity was incorrect.

(2) AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*, addresses situations when auditors determine subsequent to the date of the report that certain necessary audit procedures were omitted from the audit.

Limited Guidance on Reporting

Audit reporting guidance is complex and extensive, and detailed coverage of the subject is beyond the scope of this course. However, a companion publication to this course—*PPC's Guide to Auditor's Reports*—covers reporting in detail. It presents audit reporting guidance in a concise format of *how to* advice and illustrates over 275 audit reports. Best practices suggest using this companion guide for audit reporting matters.

COMMITMENTS AND CONTINGENCIES

Commitments and contingencies are uncompleted transactions or uncertainties that should be disclosed (and sometimes their amounts accrued) because of their effect on current financial position or future operating results. Commitments are contractual obligations for a future expenditure. Contingencies are existing conditions that create a current obligation that needs to be accrued or that might create an obligation in the future that needs to be disclosed in the financial statements. Contingencies arise from past transactions or events. Contingencies include both contingent assets and contingent liabilities, but the primary accounting and auditing focus is on contingent liabilities because contingent assets are not recognized until realized. From an auditor's perspective, the primary objectives are determining whether all significant commitments and contingencies have been identified (*completeness*), assessing their financial effect (*valuation*), and evaluating presentation and disclosure *(completeness, understandability, and valuation)*.

Accounting Standards

Commitments. Commitments are usually long-term contractual obligations with suppliers or customers for future purchases or sales at specified prices and sometimes at specified levels. The terms of commitments should be

disclosed and provision should be made for any material losses expected to be sustained. FASB ASC 440, *Commitments*, requires disclosure of commitments under unconditional purchase obligations that are associated with suppliers' financing, whether recognized in the balance sheet or not. (FASB ASC 440 also requires disclosure of maturities of long-term debt.

Contingencies. Under FASB ASC 450, *Contingencies*, the proper accounting treatment of contingencies depends on the *likelihood* (probable, reasonably possible, or remote) that the future event will confirm that a gain or loss has occurred, and on the ability to make a reasonable estimate of the outcome.

a. Accrual of loss contingencies is required if both of the following conditions are met:

   (1) Information available *prior* to financial statement issuance indicates that it is *probable* that an asset had been impaired or a liability incurred *at* the date of the financial statements.

   (2) The amount of the loss is reasonably estimable.

b. If no accrual is made for a loss contingency because one or both of the above conditions are not met and yet there is a *reasonable possibility* that a loss may have been incurred, certain disclosures are necessary:

   (1) Nature of the contingency.

   (2) An estimate of the loss or range of the loss or a statement that an estimate cannot be made. In certain circumstances, information may become available *prior* to the issuance of financial statements, indicating that an asset was impaired or a liability incurred *after* the date of the financial statements or indicating that there is a reasonable possibility of that situation. In such cases, accrual is not appropriate; however, disclosure may be necessary. Disclosure may include pro forma supplemental financial data.

   (3) Disclosure of unasserted claims is not necessary unless an underlying event has occurred indicating a potential loss or liability and:

      (a) It is probable that a claim will be asserted, and

      (b) It is reasonably possible that the outcome would be unfavorable if the claim were asserted.

c. Accounting treatment for gain contingencies:

   (1) Contingencies that might result in gains usually are not reflected in the accounts, because to do so might recognize revenue prior to its realization.

   (2) Adequate disclosure should be made of contingencies that might result in gains, but care should be exercised to avoid misleading implications as to the likelihood of realization.

Guarantees. FASB ASC 460, *Guarantees*, clarifies the application of FASB ASC 450 to guarantees, and provides measurement and disclosure guidance for guarantees. (FASB ASC 460 includes characteristic-based guidance for determining which guarantee contracts are subject to its provisions.) According to the guidance, a guarantor is required to recognize a liability for the fair value of a guarantee at inception because the guarantor's obligation to stand ready to perform under a guarantee is noncontingent. At the inception of a guarantee, therefore, guarantors should recognize a liability for the guarantee equal to the greater of (a) the fair value of the guarantor's obligation (the noncontingent element) or (b) the loss contingency that should be recognized under FASB ASC 450-20-30 (that is, the amount of future payments under the guarantee that are probable and can be reasonably estimated). The noncontingent element is taken to income in relation to the organization's release from risk under the guarantee.

Audit Procedures

Initially, an auditor's objective is to determine whether all significant contingencies and commitments have been identified. Naturally, there is greater difficulty in discovering transactions or events that may be unrecorded than in

substantiating recorded information. Once an auditor has identified commitments and contingencies, evaluation of valuation and disclosure can usually be accomplished. The auditor may be aware of possible commitments or contingencies from knowledge of the entity's business and operating characteristics and the industry in which it operates. Some contingencies or commitments may be discovered as a result of audit procedures applied for specific financial statement components. For example, an income tax dispute may be identified in the audit of income tax expense; commitments to purchase raw materials may be identified in applying audit procedures to inventory; environmental hazards may be identified during impairment testing for property.

Other audit procedures that are often used to search for contingencies and commitments include:

a. Inquiring of management about the possibility of unrecorded contingencies or commitments. (These inquiries and responses are documented in the management representation letter explained later in this course.)

b. Reading minutes of directors' or stockholders' meetings.

c. Reading contracts, loan agreements, leases, and similar documents.

d. Reviewing legal expenses and invoices and correspondence from lawyers.

e. Reviewing communications from relevant local, state, and federal agencies such as the Environmental Protection Agency.

f. Reviewing transactions subsequent to the balance sheet date.

g. Sending a letter of inquiry to legal counsel.

Some contingencies and commitments stem from financing transactions or arrangements with financial institutions, e.g., oral and written guarantees, letters of indemnity, endorsements, and open letters of credit. After identifying such matters and gaining an understanding of them, the auditor can consider confirming the details with the appropriate party at the financial institution responsible for the client's account.

Litigation, claims, and assessments are often the cause of significant contingencies. An auditor's search for those contingencies is accomplished by a related set of inquiries and communications involving the client's management and lawyers. According to AU-C 501.18, auditors should seek direct communication with the entity's external legal counsel through a letter of inquiry prepared by management and sent by the auditor, which requests the entity's legal counsel to communicate directly with the auditor. Such communication is also required from in-house legal counsel when the entity's in-house legal counsel has responsibility for the entity's litigation, claims, and assessments.

A guarantor is required to recognize a liability for the fair value of a guarantee at inception. Auditors consider the existence of guarantees and whether the guarantor's obligation to stand ready under the guarantee has been given appropriate recognition in the financial statements. Because the obligation to stand ready is recorded at fair value, the guidance in AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, applies.

ENVIRONMENTAL REMEDIATION LIABILITIES

Environmental remediation liabilities are a specific type of contingent liability that presents an auditing challenge for many firms. This area is challenging because of the number of applicable state and federal laws, the number of industries affected, and the possibility that many years may elapse between the contamination event and identification of the liability. Guidance on accounting for environmental remediation liabilities is provided by FASB ASC 410, *Asset Retirement and Environmental Obligations*. *PPC's Guide to Preparing Financial Statements*, provides an in-depth discussion of environmental laws and accounting for environmental remediation liabilities.

Accounting Standards

FASB ASC 450, *Contingencies* requires that a loss contingency be recorded if it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is estimable. Due to the number of steps involved in an environmental remediation and the time period covered, it may be difficult for an entity to estimate its liability. When attempting to reasonably estimate the loss, FASB ASC 450-20 should be applied. The guidance makes it clear that if no single loss amount can be estimated, a range of loss should be used. If a number within the range is considered a best estimate, that amount should be accrued. Otherwise, the minimum amount in the range should be accrued.

Some auditors believe that the strict liability provisions of federal Superfund Laws make it probable that an entity has incurred a liability if it is associated with a site for which a claim or assessment has been asserted (or is probable of assertion). Best practices indicate that an auditor will evaluate each case based on the site's individual facts and circumstances. However, if a client has been notified that it is a potentially responsible party (PRP) for a site, any conclusion that the entity's risk of loss is other than probable ought to be carefully considered and documented.

Audit Procedures

To identify instances of noncompliance with laws and regulations (such as environmental regulations) that may have a material effect on the financial statements, in accordance with AU-C 250.14, auditors should (a) inquire of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations, and (b) inspect correspondence, if any, with the appropriate licensing or regulatory authorities. The extent of other procedures performed for environmental liabilities depends on the company's potential to incur such liabilities. Questions auditors may ask to evaluate a company's potential for environmental remediation liabilities are included in Exhibit 1-1. If there is an increased risk that the company has environmental remediation liabilities, auditing procedures generally are the same procedures applied for other contingent liabilities (that is, reading the minutes of director's or stockholders' meetings, making inquiries of the client's attorney, and making inquiries of the client). However, due to the nature of the liability, some auditors expand their inquiries to include managers in production areas. Some of the inquiries auditors may make of management when an increased risk is identified include whether they have:

- Considered environmental matters that may materially affect the financial statements.
- Established effective policies and procedures to assess and record information on environmental matters.
- Been notified that the entity has been designated as a PRP or otherwise has an increased risk of exposure to environmental liabilities.

Exhibit 1-1

Questions for Identifying an Increased Risk of Environmental Liabilities

Is the entity in an industry at a higher risk for environmental liabilities (for example, real estate, mining, health care, dry cleaners, gas stations, farming, etc.)?

Is there any indication the entity has violated environmental laws? (Complying with the law in force at the time a toxic substance is disposed of normally does not free the entity from its liabilities for cleaning up the site, but any penalties may be reduced.)

Does the entity use or generate regulated substances in its business?

Is the entity required to have a permit to transport, store, treat, or dispose of hazardous wastes?

Has the entity ever used landfills, underground storage tanks or barrels that contain hazardous substances?

Are there any pending civil or criminal investigations related to environmental issues?

Have regulatory authorities or environmental consultants issued any reports on property the entity is associated with, such as site assessments or impact studies?

Are there any requirements for site clean-up of any property abandoned, purchased, or closed during the period? Any intentions for future removal and site restoration?

Has the entity retained any environmental remediation liabilities for any sites it has sold?

* * *

Auditors frequently obtain information about potential environmental liabilities through the attorney's letter. If the entity has been notified that a potential liability exists for a site with which it is or has been associated, the auditor would normally probe through additional inquiry and analysis an assertion by the entity's attorney that the risk of loss is other than probable.

Auditing the Estimated Liability. If a client has been designated a PRP or has an increased risk of exposure, auditors obtain an understanding of the method used to estimate the liability. If the client uses an attorney, engineer, or other specialist to make the estimate, the guidance on use of a specialist should be followed.

In addition to the general information discussed later in this course, auditors may also consider information such as the following when assessing the adequacy of the client's estimate for environmental remediation liabilities:

- The client's previous cleanup experience, if any.
- The cleanup experiences of other companies in similar circumstances.
- Data released by the EPA or other organizations.

Auditing Potential Recoveries. The client may be able to file a claim for recovery of its remediation costs from insurers, nonparticipating PRPs, prior property owners, and governmental or third-party funds. Potential recoveries are be evaluated separately from the related liability. To assess whether recovery of a potential claim is probable, auditors generally need to confirm recoverable amounts directly with the insurer, nonparticipating PRPs, or any specialized legal counsel that is involved. In addition, auditors will generally need to obtain evidence about the collectibility of receivables from these parties. Auditors generally will also need to make inquiries of the client's legal counsel. Unless there is a legal right of offset, potential recoveries are not netted against potential liabilities.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Nate is performing an audit of Tempo Fitness. Which of the following would provide Nate with guidance on how to conclude the audit versus providing information that would affect the general procedures of an audit?

    a. AU-C 520.

    b. AU-C 560.

    c. AU-C 570.

    d. AU-C 580.

2. Which of the following statements regarding commitments and contingencies is correct?

    a. Commitments arise from past transactions or events.

    b. Contingencies include contingent liabilities and contingent assets.

    c. Contingencies are contractual obligations for future expenditure.

3. Which of the following statements regarding environmental remediation liabilities is correct?

    a. When trying to reasonably estimate loss, auditors should refer to FASB ASC 410.

    b. Auditors cannot use the same auditing procedures that are applied for other contingent liabilities when there is an increased risk that a company has environmental remediation liabilities.

    c. Auditors should use a range of loss if no single loss amount can be estimated.

    d. Auditors rarely obtain information about possible environmental liabilities through the attorney's letter.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Nate is performing an audit of Tempo Fitness. Which of the following would provide Nate with guidance on how to conclude the audit versus providing information that would affect the general procedures of an audit? **(Page 294)**

   a. AU-C 520. [This answer is correct. AU-C 520, *Analytical Procedures*, provides the auditor with information on the required use of analytical procedures in the review stage of the audit.]

   b. AU-C 560. [This answer is incorrect. AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, provides guides when auditors subsequently become aware of facts that existed at the date of the report that might have caused them to believe that the entity provided incorrect information.]

   c. AU-C 570. [This answer is incorrect. As one of the general procedures of an audit, AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, gives guidance on the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.]

   d. AU-C 580. [This answer is incorrect. AU-C 580, *Written Representations*, requires that the auditor obtain certain representations from management.]

2. Which of the following statements regarding commitments and contingencies is correct? **(Page 295)**

   a. Commitments arise from past transactions or events. [This answer is incorrect. Contingencies arise from past events or transactions.]

   b. Contingencies include contingent liabilities and contingent assets. [This answer is correct. Contingencies include both contingent assets and contingent liabilities, but the primary accounting and auditing focus is on contingent liabilities because contingent assets are not recognized until realized.]

   c. Contingencies are contractual obligations for future expenditure. [This answer is incorrect. Commitments are contractual obligations for a future expenditure.]

3. Which of the following statements regarding environmental remediation liabilities is correct? **(Page 298)**

   a. When trying to reasonably estimate loss, auditors should refer to FASB ASC 410. [This answer is incorrect. When attempting to reasonably estimate the loss, FASB ASC 450-20 should be applied.]

   b. Auditors cannot use the same auditing procedures that are applied for other contingent liabilities when there is an increased risk that a company has environmental remediation liabilities. [This answer is incorrect. If there is an increased risk that the company has environmental remediation liabilities, auditing procedures generally are the same procedures applied for other contingent liabilities (that is, reading the minutes of director's or stockholders' meetings, making inquiries of the client's attorney, and making inquiries of the client).]

   c. Auditors should use a range of loss if no single loss amount can be estimated. [This answer is correct. The guidance in FASB ASC 450-20 states that if no single loss amount can be estimated, a range of loss should be used.]

   d. Auditors rarely obtain information about possible environmental liabilities through the attorney's letter. [This answer is incorrect. Auditors frequently obtain information about potential environmental liabilities through the attorney's letter.]

LITIGATION, CLAIMS, AND ASSESSMENT

Introduction and Authoritative Literature

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, among other topics, addresses the procedures that auditors should follow for identifying an entity's litigation, claims, and assessments that may result in a risk of material misstatement. The authoritative guidance related to litigation, claims, and assessments is found in paragraphs AU-C 501.03; AU-C 501.16–.24; and application guidance is found in paragraphs AU-C 501.A39–.A65. Additionally, AU-C 501.A69 provides an illustrative audit inquiry letter to legal counsel.

In 1975, the AICPA and the American Bar Association reached an accommodation in regards to the information auditors would expect legal counsel to provide. Before that, there was a growing reluctance on the part of lawyers to disclose privileged information, e.g., unasserted claims, and to predict the success of their own efforts in handling litigation. The accommodation reached hinges primarily on differing treatments for pending or threatened litigation versus unasserted claims.

Objectives and Requirements

The following paragraphs summarize the objectives and requirements for litigation, claims, and assessments under AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*.

The objective of the auditor is to obtain sufficient appropriate audit evidence about the completeness of the entity's litigation, claims, and assessments. The requirements that should be followed to achieve that objective are summarized in Exhibit 1-2.

Exhibit 1-2

Requirements for Litigation, Claims, and Assessments

Requirements	AU-C Reference
Design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to risks of material misstatement, including the following: • Inquiring of management and, when applicable, others within the entity, including in-house legal counsel. • Obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements and during the period from the date of the financial statements to the date the information is furnished, including an identification of matters referred to legal counsel. • Reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel. • Reviewing legal expense accounts and invoices from external legal counsel.	AU-C 501.16
For actual or potential litigation, claims, and assessments identified based on the immediately preceding audit procedures, obtain audit evidence relevant to the following: • The period in which the reason for the legal action occurred. • The probability of an unfavorable outcome. • The amount or range of potential loss.	AU-C 501.17
Unless the preceding audit procedures indicate that no actual or potential litigation, claims, or assessments that may give rise to risks of material misstatement exist, seek direct communication with the entity's external legal counsel through a letter of inquiry prepared by management and sent by the auditor requesting the external legal counsel to communicate directly with the auditor.	AU-C 501.18

Requirements	AU-C Reference
In addition to direct communications with the entity's external legal counsel, in cases when the entity's in-house legal counsel has responsibility for the entity's litigation, claims, and assessments, seek direct communication with the entity's in-house legal counsel through a letter of inquiry similar to the letter sent to external legal counsel.	AU-C 501.19
Document the basis for any determination not to seek direct communication with the entity's legal counsel.	AU-C 501.20
Request management to authorize the entity's legal counsel to discuss matters with the auditor.	AU-C 501.21
Request in the letters of inquiry that the entity's legal counsel inform the auditor of any litigation, claims, assessments, and unasserted claims of which the counsel is aware, together with an assessment of the outcome of the litigation, claims, and assessments, and an estimate of the financial implications, including costs involved. Include the following in each letter: • Identification of the entity, including subsidiaries, and the audit date. • A list prepared by management (or a request by management that the legal counsel prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments about which the legal counsel has been engaged and to which they have devoted substantive attention in the form of legal consultation or representation. • A list prepared by management that describes and evaluates unasserted claims and assessments that management considers probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome about which the legal counsel has been engaged and to which they have devoted substantive attention in the form of legal consultation or representation. • For items of pending or threatened litigation, claims, and assessments, a request that the legal counsel either provide the following information or comment on matters where the legal counsel's views differ from those stated by management: •• A description of the nature of the matter, the progress of the case to date, and the action that the entity intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement). •• An evaluation of the likelihood of an unfavorable outcome and an estimate, if practicable, of the amount or range of potential loss. •• An identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete. • For unasserted claims and assessments, a request that the legal counsel comment on matters where the legal counsel's views concerning the description or evaluation of the matter differs from those stated by management. • A statement that management understands that, whenever in the course of performing legal services for the entity with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the legal counsel has formed a professional conclusion that the entity should disclose or consider disclosure of such possible claim or assessment, the legal counsel, as a matter of professional responsibility to the entity, will so advise the entity and will consult with the entity concerning such disclosure and the requirements of GAAP. • A request that the legal counsel confirm whether the understanding described in the immediately preceding item is correct. • A request that the legal counsel specifically identify the nature of, and reasons for, any limitation on the response. • A request that the legal counsel specify the effective date of the response.	AU-C 501.22

Requirements	AU-C Reference
When the auditor is aware that an entity has changed legal counsel or that the previously engaged legal counsel has resigned, consider making inquiries of management or others about the reasons the legal counsel is no longer associated with the entity.	AU-C 501.23
Modify the auditor's opinion in accordance with AU-C 705 if— • the entity's legal counsel refuses to respond appropriately to the letter of inquiry and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative procedures, or • management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.	AU-C 501.24

* * *

Inquiry of Legal Counsel

AU-C 501.18 requires the auditor to seek direct communication with the entity's legal counsel unless the procedures performed to identify litigation, claims, and assessments do not indicate any actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement. Procedures used to identify litigation, claims, and assessments are included in the other audit procedures often used to search for commitments and contingencies that are discussed earlier in this course. In a small business engagement, the entity generally engages outside legal counsel for all litigation, claims, and assessments. However, communication is also required from in-house legal counsel (if any) when the entity's in-house legal counsel has responsibility for the entity's litigation, claims, and assessments. In such circumstances, in-house legal counsel may be in the best position to know and describe the status of litigation, claims, and assessments or to corroborate the information provided by management. In the situation where the auditor does not seek direct communication with the entity's legal counsel, the auditor should document the basis for that decision.

Pending or Threatened Litigation

The letter is from the client (with the auditor controlling mailing the letter) and asks the lawyer to provide or corroborate directly with the auditor the following information concerning pending or threatened litigation:

a. The nature of the litigation.

b. The progress of the case to date.

c. How management is responding or intends to respond to the litigation (for example, to contest the case or to seek an out-of-court settlement).

d. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

e. A statement that the list of matters is complete or an identification of the omission of any pending or threatened litigation, claims, and assessments.

This information needs to be obtained for each individual case for which legal counsel has devoted substantive legal consultation or representation on behalf of the entity. A collective evaluation is not sufficient except for litigation that the lawyer handling the litigation has evaluated in the aggregate in accordance with materiality limits specified by the auditor.

There are two approaches to obtaining this information:

a. *List Prepared by Client's Lawyer (Short-form).* This approach asks the lawyer to prepare the information rather than comment on management's list. This approach also can be used if the client represents that

there are no unasserted claims or assessments that are probable of assertion and should be disclosed in accordance with FASB ASC 450, *Contingencies*. Actually, the ABA has expressed a preference for this approach and, as a practical matter, a client-prepared list is prepared with the lawyer's advice. This approach is usually best suited to a small business engagement.

b. *List Prepared By Client Management (Long Form).* This approach asks the lawyer to comment on the completeness of information prepared by the client on the details of each case listed as pending or threatened litigation.

Both letters include a specified materiality limit. Generally, this is preferable. If a lawyer responds using a materiality level that is too large for the auditor's purposes, a follow-up inquiry would be necessary. The materiality amount used is generally some fraction of performance materiality. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors.

Unasserted Claims and Assessments

The approach to unasserted claims is indirect. Lawyers will not furnish an auditor with information on unasserted claims and assessments because of concern about preserving the attorney-client privilege, nor will they confirm the completeness of information furnished by management. Assurance is obtained indirectly by the following process:

a. The lawyer is asked to confirm that whenever the lawyer is aware of an unasserted claim requiring disclosure according to FASB ASC 450, the lawyer will advise the client.

b. Management is asked to represent to the auditor that management has informed the auditor of any claims the lawyer has advised are required to be disclosed. (Usually this representation is obtained in a management representation letter.)

c. The auditor informs the lawyer of management's representation on unasserted claims. (Usually, this is covered in the inquiry letter to the lawyer, and normally, especially in a small business engagement, the representation is that there are no unasserted claims.)

Presumably, the lawyer would recognize a professional duty to resign if management fails to disclose to the auditor a matter that the lawyer believes will give rise to material claims or assessments if asserted. AU-C 501.A55 observes that the legal counsel's relevant ethical requirements may require resignation if his or her advice on financial accounting and reporting for litigation, claims, and assessments is disregarded by the entity. A primary example of that circumstance arises if the management tells the auditor there is no unasserted possible claim or assessment that should be disclosed or considered for disclosure when the legal counsel has in fact advised management about such a matter. At a minimum, the legal counsel could not sign a response letter to the auditor in those circumstances. The possibility of a dispute about disclosure leading to legal counsel's resignation is a reason that AU-C 501.23 requires the auditor to consider making inquiries of management or others about the reason legal counsel is no longer associated with the entity. The auditor might identify that legal counsel has resigned when reviewing legal expense accounts and invoices from legal counsel.

Client Has Not Consulted a Lawyer

In some small business engagements, the client has had no need to consult a lawyer about pending or threatened litigation or claims. (However, the client may have consulted a lawyer for other reasons, such as matters related to collection of receivables, drafting of contracts, etc.) As long as the entity has no material litigation, claims, or assessments, it is generally not necessary to request a legal representation letter from the client's attorney. An auditor can rely on other audit procedures, to disclose the existence of contingencies, including litigation, claims, and assessments. If an auditor's other procedures do not identify the existence of material claims or assessments, nor indicate that a lawyer was consulted regarding such matters, no additional procedures are necessary. However,

best practices suggest that the written representation obtained from management as it relates to litigation, claims, and assessments be modified as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with GAAP, and we have not consulted a lawyer concerning litigation, claims, or assessments.

This representation would take the place of those representations ordinarily obtained about litigation, claims, and assessments.

In some situations, if the auditor believes that actual or potential material litigation, claims, or assessments possibly exist, but the entity has not engaged external legal counsel relating to such matters, the auditor may discuss with the client the need to consult legal counsel to appropriately determine the effect to the entity's financial statements. If the auditor believes the matter may be significant, refusal by management to consult legal counsel may result in a scope limitation sufficient enough to preclude an unmodified opinion.

Evaluation of Lawyers' Responses

When the short-form inquiry is used, the auditor should make sure that the attorney's response is complete, i.e., that for each case or asserted claim or assessment the attorney identifies, all five items of information listed earlier are addressed. The response should be addressed to the auditor and cover matters existing at year end and through the date of the auditor's report. In addition, when material litigation or claims are identified, an auditor needs to consider the lawyer's assessment of the probability of an unfavorable outcome. The need to accrue or disclose a loss contingency is affected by the likelihood of an unfavorable outcome.

According to the ABA Statement of Policy on lawyers' letters (reprinted as EXHIBIT A to AU-C 501), a lawyer may indicate whether an outcome is probable or remote, if that determination can be made. However, the lawyer is not required to use those terms, and an auditor needs to carefully evaluate the wording used.

The auditor needs to carefully evaluate the wording of the lawyer's assessment of the probability of an unfavorable outcome. Specifically, the auditor needs to decide whether the response is clear regarding a probable or remote outcome because the need to accrue the contingency depends on such determination. Exhibit 1-3 presents examples of clear and unclear wording, based on guidance in AU-C 501.A65.

Exhibit 1-3

Examples of Lawyers' Responses

1. **Responses That Clearly Indicate an Unfavorable Outcome Is Remote:**

   a. "We are of the opinion that this action will not result in any liability to the company."

   b. "We believe that the plaintiff's case against the company is without merit."

   c. "We believe the company will be able to defend this action successfully."

   d. "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

   e. "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."

2. **Responses That Are Unclear on Likelihood of Outcome:**

   a. "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."

b. "We believe the action can be settled for less than the damages claimed."

c. "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation."

d. "In our opinion, the company has a substantial chance of prevailing in this action."

e. "It is our opinion that the company will be able to assert meritorious defenses to this action."

* * *

The examples that are unclear talk around the point without taking a solid position. For example, terms like *substantial chance* and *reasonable opportunity* indicate more uncertainty than an opinion that the company will prevail. The term *meritorious defenses* means only that the defenses will not be summarily dismissed by the court.

In some instances, the attorney may limit his or her response in ways other than that specified by the original request. For example, instead of limiting the response based on a specified materiality limit the attorney may limit the response to cases in which six or more hours have been billed. In that situation, the auditor needs to assess the potential effect of the limitation on the attorney's response. A limitation based upon billable hours is generally not appropriate because it does not necessarily correlate to the amount of the contingent liability. Consequently, if an attorney's response has a billable hours limitation, the auditor will generally need to ask the client to have the attorney respond based on the materiality limits specified in the original request.

Some lawyers add statements in their responses to emphasize retention of the attorney-client and attorney work product privileges. An example of such statements follows:

> [Name of Company] has advised us that the request made in its letter to us is not intended to be a waiver of the attorney-client privilege relating to any information the Company had furnished to us. Furthermore, be advised that our response to you should not be interpreted as a waiver of the protection of the attorney work product privilege relating to any of our files involving [Name of Company].

According to AU-C 501.A61, such comments in lawyers' letters are not limitations on the scope of their responses. Thus, those comments do not affect the auditors' evaluations.

With respect to unasserted possible claims or assessments, some attorneys also include language such as the following in their responses to emphasize the preservation of attorney-client privilege:

> Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the company. We can only furnish information concerning those unasserted possible claims or assessments upon which the company has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

According to AU-C 501.A62, such language is not a limitation on the scope of the audit as long as the lawyer's response includes a confirmation of the understanding that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted claims or assessments.

If the auditor obtains an oral response concerning matters covered by the audit inquiry letter, the auditor should document conclusions reached and the basis for that conclusion provided by the legal counsel's oral response concerning the need to account for or disclose litigation, claims, and assessments.

Dating of Lawyer's Response. The letter from the client's lawyer needs to be coordinated with the date of the auditor's report. Accordingly, it is preferable for the letter to be dated to cover a period that closely corresponds to the auditor's report date, usually within two weeks of the report date. (In some circumstances, e.g., when there are volatile litigation proceedings, the auditor might want to confirm the continued appropriateness of the lawyer's response as of a date nearer to the report date.) If the attorney's response does not specify an effective date, the auditor can assume that the date of the response is the effective date. If the lawyer's response is dated too long before the date of the auditor's report, the auditor needs to consider getting an updated response. If the update is obtained orally, it should be documented in the workpapers. If significant matters (such as new litigation or significant developments relating to old litigation) are discovered in the oral update, best practices suggest obtaining a written update from the attorney.

Scope Limitations Related to Litigation, Claims, and Assessments

If an external legal counsel refuses to furnish the information requested in an audit inquiry letter, either in writing or orally, according to AU-C 501.A58, that may cause a scope limitation of the audit sufficient to preclude an unmodified opinion. The limitations inherent in the form of inquiry described by AU-C 501.22 (see Exhibit 1-2) are not scope limitations. Information on pending or threatened litigation, claims, and assessments is appropriately limited to matters as to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention.

The legal counsel does not provide information on the existence of unasserted claims and might further include language in the response to preserve lawyer-client privilege. This language does not constitute a scope limitation. Maintaining privilege is the same reason the legal counsel is not requested to provide a list of unasserted claims and to comment only on such matters the client has already disclosed to the auditor.

Because of the lawyer-client privilege, the client might identify certain documents as subject to the lawyer-client privilege and not permit the auditor to examine them. Whether this would be considered a scope limitation depends on the circumstances. AU-C 501.A59 points out that if there are such questions about the applicability of the privilege, the auditor may request legal counsel's confirmation that the information is subject to that privilege and that the information was considered by the legal counsel in responding to the letter of inquiry. Best practices indicate that unless the auditor is able to obtain such confirmation, the matter does constitute a scope limitation.

As noted in AU-C 501.A60, if management imposes a scope limitation on the audit and the auditor cannot obtain sufficient appropriate audit evidence through alternative procedures, a disclaimer of opinion should be rendered or, when practical, the auditor might withdraw from the engagement.

WRITTEN REPRESENTATIONS

Introduction and Authoritative Literature

AU-C 580.09, *Written Representations* requires the auditor to request written representations from management with appropriate responsibilities for the financial statements. Among other things, AU-C 580.10 requires the auditor to request management to provide specific representations that it has fulfilled the responsibilities concerning the terms of the audit engagement for:

- Preparation and fair presentation of the financial statements.
- Design, implementation, and maintenance of internal control relevant to preparation and presentation of financial statements that are free of material misstatements due to error or fraud.
- Providing all relevant information and access.
- Recording and reflecting all transactions in the financial statements.

AU-C 580.25 indicates that with respect to the representations required by AU-C 580.10–.11 if (a) management does not provide them, or (b) the auditor concludes that sufficient doubt exists about management integrity that

these representations are not reliable, then the auditor is required to disclaim an opinion in accordance with AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, or withdraw from the engagement.

AU-C 580 and other auditing standards require the auditor to request other written representations from management. In addition, the auditor may request other written representations that he or she considers appropriate in certain situations. AU-C 580.12–.18 requires the auditor to request management to provide specific written representations related to the following matters:

- Fraud.
- Laws and regulations.
- Uncorrected misstatements.
- Litigation and claims.
- Estimates.
- Related party transactions.
- Subsequent events.

AU-C 580.26 indicates that when management does not provide one or more of the other written representations requested, the auditor should, (a) discuss the omission with management, (b) reevaluate management's integrity, (c) evaluate the implications for the reliability of management's other written or oral representations and audit evidence generally, and (d) take appropriate actions. Appropriate actions include determining the possible effect on the auditor's report pursuant to the guidance provided by AU-C 705.

With respect to these other specific representations required by AU-C 580.12–.18, representations required by other AU-C sections, or any additional representations the auditor believes necessary in the circumstances, management's refusal to provide them is a scope limitation, and is often sufficient to preclude an unmodified opinion. Specifically with respect to the representations identified in AU-C 580.12–.18, management's refusal may cause the auditor to withdraw or disclaim an opinion. AU-C 580.A34, however, explains that, depending on the nature or the representations not obtained or the circumstances of the refusal, a qualified opinion rather than a disclaimer may be appropriate. For the written representations required by AU-C 580.10–.11, as explained earlier in this section, a disclaimer or withdrawal is always required.

Objectives and Requirements

The following paragraphs summarize the objectives and requirements for management representations under AU-C 580, *Written Representations*.

The objectives of the auditor when obtaining written representations are:

a. To obtain representations from management and, if applicable, those charged with governance, that they have fulfilled their responsibility for the preparation and fair presentation of the financial statements and for the completeness of information provided to the auditor.

b. To obtain support for other audit evidence when considered necessary by the auditor or when required by other standards.

c. To respond appropriately to written representations that are provided (or are not provided when the auditor has requested them).

Detailed Requirements for Written Representations. The detailed requirements on specific written representations the auditor should request are described in Exhibit 1-4 along with reference to the AU-C source of the requirement. Exhibit 1-4 provides requirements for certain other written representations that originate from auditing

standards other than AU-C 580. The authors recommend auditors consider certain other representations that are not provided in auditing standards, but may be advisable when there is an owner-manager of a small business as discussed later in this section.

Exhibit 1-4

Requirements for Written Representations

Requirements	AU-C Reference
Written Representations	
Request written representations from management with appropriate responsibility for the financial statements and knowledge of the matters involved. (Management includes, when appropriate, those charged with governance.) The written representations are obtained in the form of a representation letter addressed to the auditor.	AU-C 580.09 AU-C 580.08 AU-C 580.21
Request management to provide written representations that it:	
• Has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with GAAP, as set out in the terms of the audit engagement.	AU-C 580.10
• Has fulfilled its responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement.	AU-C 580.10
• Has provided the auditor with all relevant information and access and that all transactions have been recorded and are reflected in the financial statements.	AU-C 580.11
• Acknowledges its responsibility for the design, implementation, and maintenance of internal controls to prevent and detect fraud.	AU-C 580.12
• Has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated due to fraud.	AU-C 580.12
• Has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control, or others when the fraud could have a material effect on the financial statements.	AU-C 580.12
• Has disclosed to the auditor its knowledge of any allegations of fraud or suspected fraud affecting the financial statements communicated by employees, former employees, regulators, or others.	AU-C 580.12
• Has disclosed to the auditor all instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements.	AU-C 580.13
• Believes the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. (A summary of uncorrected misstatements should be included in, or attached to, the written representation.)	AU-C 580.14
• Has disclosed to the auditor all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements, and has properly accounted for and disclosed such items.	AU-C 580.15
• Believes the significant assumptions used in making accounting estimates are reasonable.	AU-C 580.16

Requirements	AU-C Reference
• Has disclosed to the auditor all related parties and related party transactions of which it is aware and has properly accounted for and disclosed related party relationships and transactions in the financial statements. • Has properly disclosed or adjusted the financial statement for all events occurring subsequent to the date of the financial statements that require disclosure or adjustment.	AU-C 580.17 AU-C 580.18
Date the written representations as of the date of the auditor's report on the financial statements.	AU-C 580.20
Obtain written representation for all financial statements and periods referred to in the auditor's report.	AU-C 580.20
Determine the effect on the reliability of the representations (oral or written), and audit evidence in general, when there are concerns about the competence, integrity, ethical values, or diligence of management.	AU-C 580.22
Perform audit procedures to attempt to resolve inconsistencies between written representations and other audit evidence. Reconsider the assessment of the competence, integrity, ethical values, or diligence of management and the effect that it may have on the reliability of representations (oral or written) and audit evidence in general if inconsistencies remain unresolved.	AU-C 580.23
Take appropriate action when there is a conclusion that written representations are not reliable, including determining the possible effect on the auditor's opinion in accordance with AU-C 705.	AU-C 580.24
Disclaim an opinion on the financial statements or withdraw from the engagement if sufficient doubt exists about the integrity of management such that its written representations are not reliable or if management does not provide representations required by AU-C 580.10-11 concerning preparation and fair presentation of financial statements or information provided and completeness of transactions.	AU-C 580.25
If management does not provide one or more of any other requested written representations: • Discuss the matter with management. • Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. • Take appropriate action, including determining the possible effect on the auditor's opinion.	AU-C 580.26
Request other written representations when it is considered necessary to support other audit evidence relevant to the financial statements or when required by other auditing standards.	AU-C 580.19
Other Requirements Related to Obtaining Written Representations	
When the auditor believes before consideration of management's plans that substantial doubt exists about an entity's ability to continue as a going concern, request the following written representations: • A description of management's plans to mitigate the adverse effects of the conditions or events identified and the probability that the plans can be implemented. • The financial statements disclose all relevant matters that management is aware of regarding the ability of the entity to continue as a going concern, as well as the conditions or events and management's plans.	AU-C 570.18[b]

Requirements	AU-C Reference
If a predecessor auditor is asked to reissue a report on prior-period financial statements, obtain written representations from management of the former client regarding whether: • Any information has come to management's attention that would cause it to believe that any of the previous representations should be modified, and • Any events occurred after the date of the financial statements the predecessor reported on that would require modification to the statements.	AU-C 560.19
If a restatement is made to correct a material misstatement in a prior period that affects comparative financial statements, obtain a specific representation regarding the restatement.	AU-C 700.53
If the auditor is engaged to report on whether supplementary information presented outside of the basic financial statement is fairly stated in relation to the financial statements as a whole, obtain the following representations from management: • That it acknowledges its responsibility for presentation of the supplementary information in accordance with GAAP. • That it believes the supplementary information is fairly presented in accordance with GAAP. • That the methods of measurement or presentation have not changed from the prior period (or the reasons for a change). • About any significant assumptions or interpretations underlying measurement or presentation of the supplementary information. • That audited financial statements will be made readily available to intended users of the supplementary information when the information is not presented with the audited statements, no later than the date the supplementary information and auditor's report are issued.	AU-C 725.07
If the auditor is engaged to report on required supplementary information that accompanies the basic financial statements, obtain the following representations from management: • That it acknowledges its responsibility for presentation of the required supplementary information. • About whether the required supplementary information is fairly presented in accordance with prescribed guidelines. • About whether the methods of measurement or presentation have changed from the prior period, and if so, the reasons for such changes). • About any significant assumptions or interpretations underlying measurement or presentation of the required supplementary information.	AU-C 730.05
If the auditor is engaged to report on summary financial statements, obtain the following representations from management: • Acknowledgment of its responsibility for preparation of the summary financial statements in accordance with the applied criteria. • That audited financial statements will be made readily available to intended users of the summary financial statements when the summary financial statements are not presented with the audited financial statements. • If the auditor's report on the summary financial statements is issued after the auditor's report on the audited financial statements, whether anything came to management's attention to cause it to believe the previous representations on the audited financial statements need modification, or whether events subsequent to the issuance of the audited financial statements necessitate modification in the audited financial statements.	AU-C 810.12

Requirements	AU-C Reference
If the auditor is engaged to report on interim financial information, the auditor should request management to provide the written representations required by AU-C 930.	AU-C 930.22
If the auditor is engaged to perform a compliance audit, the auditor should request management to provide the written representations required by AU-C 935.	AU-C 935.23

Notes:

[a] AU-C 580.A15 suggests that it may be appropriate to obtain written representations about related parties from those charged with governance in addition to management.

[b] Information about reporting on required supplementary information pursuant to AU-C 730 is included in *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Homeowners Associations*.

[c] SAS No. 132 (AU-C 570), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* will supersede SAS No. 126 (AU-C 570A), when effective. SAS No. 132 is effective for audits of financial statements for periods ending on or after December 15, 2017. The auditor's consideration of the entity's ability to continue as a going concern is discussed later in this course.

* * *

Written Representations as Audit Evidence

Written representations provide audit evidence, but according to AU-C 580.03–.04, do not on their own provide sufficient appropriate evidence about the matters dealt with in the representations. Obtaining reliable written representations is necessary to express an opinion, but does not affect the nature, timing, or extent of procedures the auditor applies to obtain evidence about management's fulfillment of its responsibilities or about specific financial statement assertions. This restraint on reliance on written representations even applies to matters of management intent and judgment. AU-C 580.A21 explains that the auditor may consider it necessary to obtain written representations to support the auditor's understanding obtained from other audit evidence about management's judgment or intent regarding, or the completeness of, a specific assertion. Management's intent, for example, may be important to the valuation of certain investments. Written representations provide necessary evidence in these circumstances, but do not on their own provide sufficient appropriate evidence. AU-C 580.A20 explains that when obtaining evidence about judgments and intentions of management, the auditor may consider one or more of the following:

- Prior history of carrying out intentions.
- Reasons for taking a particular course of action.
- Ability to follow a specific course of action.
- Information, or lack thereof, obtained during the audit that may be inconsistent with judgments or intentions of management.

Thus, even in the case of matters such as management's judgments and intentions, the auditor cannot rely solely on written representations.

Form of Written Representations

AU-C 580.21 specifically requires that written representations be obtained in the form of a representation letter addressed to the auditor. Exhibit A to AU-C 580 provides an illustrative example of a representation letter.

Uncorrected Misstatements

AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter. AU-C 580 does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation (that is, when either no misstatements are noted in the audit or all noted misstatements are corrected), best practices indicate no representation about uncorrected misstatements is necessary in the management representation letter.

Uncorrected misstatements communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor's attention by management. For example, it is not uncommon for the client to inform the auditor about adjustments of which the client is aware. If those adjustments are not recorded, they should be included in the summary attached to the management representation letter. The summary of uncorrected misstatements also may include the current year effect of unadjusted audit differences from prior years (that is, the turnaround effect). The guidance stated later in this course provides information about summarizing the current year effect of unadjusted audit differences from prior years. In addition, as discussed later in this course, some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences. Those misstatements (often referred to as trivial misstatements or differences passed at the workpaper level) need not be included in the summary of uncorrected misstatements communicated in the management representation letter.

If the auditor aggregates the misstatements, they normally would be aggregated by financial statement caption, but other methods are acceptable, such as by business segment or subsidiary. Amounts need to be presented in sufficient detail to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements.

Exhibit 1-5 illustrates an example summary of audit differences that can be included in or attached to the representation letter. Other approaches for complying with the requirement to communicate uncorrected misstatements also are acceptable, such as summarizing the uncorrected misstatements within the body of management's representation about uncorrected misstatements. This may entail a greater degree of summarization than would be presented in a separate schedule. For example, the representation about uncorrected misstatements from Plas-Cup, Inc., the illustrative company used in Exhibit 1-5, might read as follows:

> We believe the effects of uncorrected financial statement misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Those misstatements result from:
>
> a. Recognizing vacation pay when paid rather than when incurred and therefore not recognizing the current liability of $10,000 and $10,500 at December 31, 20X1 and 20X2, respectively, or the related compensation expense;
>
> b. Recognizing audit fees when paid rather than when incurred and therefore not recognizing the current liability of $5,000 and $5,200 at December 31, 20X1 and 20X2, respectively, or the related professional services expense;
>
> c. Overestimating the $50,000 provision for warranty costs on the company's new product line by $5,000; and
>
> d. Recognizing the $7,500 cost of equipment purchased in December 20X1 as an expense of that year and therefore not recognizing the equipment's net book value of $7,500 and $6,750 at December 31, 20X1 and 20X2, respectively, or the additional depreciation expense of $750 for 20X2.

This example omits some of the information that is included in the separate schedule illustrated in Exhibit 1-5 under the assumption that the auditor believes the information in items a.–d. is sufficient to communicate the uncorrected misstatements.

Exhibit 1-5

Illustrative Summary of Audit Differences for Inclusion in or Attachment to the Management Representation Letter[a]

PLAS-CUP, INC.
SUMMARY OF AUDIT DIFFERENCES
Year Ended December 31, 20X2

	Current Year Over (Under) Statement
Income statement misstatements:[b]	
Failure to accrue 20X2 paid vacation	$ 10,500
Unaccrued 20X2 audit fees, incurred by year end	5,200
Excess provision for warranty costs	(5,000)
Depreciation expense on $7,500 of capital equipment expensed in 20X1	750
Pretax effect	11,450
Tax effect (34% effective tax rate)	(3,893)
Cumulative effect (before effect of prior year differences)	7,557
Effect of unadjusted audit differences—prior year (net of tax):	
Unaccrued 20X1 paid vacation	(6,600)
Unaccrued 20X1 audit fees, incurred by year end	(3,300)
Cumulative effect (after effect of prior year differences)	$ 2,343
Reclassification adjustments:	
Current deferred income tax asset	$ (5,100)
Noncurrent deferred income tax liability	(5,100)
Balance sheet misstatements (including reclassifications):[c]	
Current assets	(5,100)
Total assets	(11,850)
Current liabilities	(10,700)
Total liabilities	(15,800)
Stockholders' equity:	
Beginning	4,950
Ending	2,607

Notes:

[a] This summary is derived from the illustrative audit difference evaluation presented at Exhibit 2-2. As discussed earlier, other approaches also are acceptable.

[b] Income statement adjustments might be presented net of their related tax effects, rather than presenting the aggregate tax effects as a separate line item. Alternatively, only pretax amounts may be presented. Auditors also might consider presenting the percentage effect on net income of cumulative income statement adjustments.

[c] The effect of uncorrected misstatements on assets and liabilities on a pretax basis and the effect of uncorrected misstatements on equity on an after-tax basis is presented. Alternatively, only pretax amounts may be presented. Auditors also might consider presenting the percentage effect on assets, liabilities, and equity.

* * *

The auditor should request management to correct misstatements accumulated during the audit, except for those that are clearly trivial. Even so, management may have reasons for refusing to correct some (or all) misstatements. In some circumstances, management may not believe that certain uncorrected misstatements are misstatements. In that situation, management may want to add wording to the representation letter such as, "We do not agree that

items . . . constitute misstatements because [description of reasons]." Obtaining such a representation does not relieve the auditor from forming a conclusion about the effect of uncorrected misstatements pursuant to AU-C 450, *Evaluation of Misstatements Identified During the Audit*. Nevertheless, compliance with AU-C 580 certainly is simplified if management records all audit adjustments. In many cases, especially for smaller businesses that rely on the auditor for accounting knowledge, management will agree to record all audit adjustments.

The communication of uncorrected misstatements in the representation letter does not constitute a communication to management (or those charged with governance) under AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, or AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. That guidance addresses different communication responsibilities as discussed later in this course. The auditor considers the client's decision to not record audit adjustments when identifying and assessing fraud risks, but the decision to not record all proposed adjustments does not necessarily mean the client is intentionally misstating the financial statements.

From Whom to Request Written Representations and Related Issues

AU-C 580.09 requires the auditor to request written representations from management with knowledge of the matters covered and with appropriate responsibilities for the financial statements. AU-C 580.A2 indicates that the appropriate individuals from whom to make the request depends on governance structure, but that the responsible party is often management and the request is made of the chief executive officer (CEO) and the chief financial officer (CFO).

Best of Knowledge and Belief. A common qualifying phrase that is used in written representations is that they are being made "to the best of management's knowledge and belief." AU-C 580.A6 indicates that the auditor may accept this qualifying language if the auditor is able to conclude that the parties making them have appropriate knowledge and appropriate responsibilities concerning the matters included in the representations. This type of modification of the language may be particularly useful for an owner-managed small business; other modification that may be useful for an owner-managed client are discussed later in this section.

Modifications for an Owner-managed Small Business

It may be advisable to modify some of the standard wording to define technical terms that may not be familiar to a small business owner/manager and, in general, to make the owner/manager more comfortable with the reasonableness of the representations being requested. For example, technical terms such as *fraud* and *related party transactions* are discussed in authoritative literature but may be unfamiliar to an owner/manager of a small business. Also, in a small business engagement, certain additional representations may be desirable.

Additional Representations. For a small business, certain additional representations may be advisable in the representation letter. For example:

a. *Adjusting Entries.* In addition to the representations related to uncorrected misstatements discussed earlier in this section, some auditors believe it is desirable to obtain management's acknowledgment of responsibility for proposed audit adjustments *booked* by the client. If there are no uncorrected audit adjustments (that is, if all misstatements noted in the audit are booked), the owner/manager might state: "I am in agreement with the adjusting journal entries you have proposed, and they have been posted to the Company's accounts." As discussed earlier in this section, in this case, no representation about uncorrected misstatements is necessary.

   If there are both corrected and uncorrected audit adjustments, the owner/manager might state: "The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. In addition, you have proposed adjusting journal entries that have been posted to the Company's accounts. I am in agreement with those adjustments."

b. *Oral Communications.* If required communications are orally reported (as permitted in certain circumstances under AU-C 260, *The Auditor's Communication with Those Charged with Governance*), it is desirable for the owner/manager to acknowledge in the representation letter that the matters have been reported.

c. *Segregation of Business and Personal Transactions.* Owner-managed businesses often have informal recordkeeping systems, and it is easy to commingle personal and business transactions. Thus, it is beneficial to have the owner/manager acknowledge that the accounts do not contain personal transactions.

d. *Provision for Unpaid Federal Income Taxes.* It may be desirable to include a representation such as: "The Internal Revenue Service has examined the Company's Federal income tax returns through [Year]. However, the Company's Federal income tax returns for [List open years.] are subject to examination by the IRS, generally for three years after they were filed. The Company recognizes tax benefits only to the extent that the Company believes it is "more likely than not" that its tax positions will be sustained upon IRS examination. Accordingly, the provision for unpaid federal income taxes (liability for unrecognized tax benefits) in the balance sheet reflects all tax positions that the Company believes do not have greater than a 50% chance of realization after examination."

e. *Pledged Assets.* Many small businesses have pledged property as collateral on debt obligations.

Alternative Wording. Exhibit 1-6 presents alternative wording that can be used in a representation letter for an owner-managed small business. The alternative wording defines technical terms and, in general, modifies the wording to make it more understandable for an owner-manager.

Other Actions. Other actions an auditor could take to maximize an owner/manager's understanding of the representation letter include discussing the letter item by item so the owner/manager agrees on the meaning and significance of the representations.

Exhibit 1-6

Examples of Alternative Wording of Representations for an Owner-managed Small Business

Standard Letter	Alternative Wording[a]
We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.	We acknowledge our responsibility for the design, implementation, and maintenance of internal control *(measures)* to prevent and detect fraud *(intentional acts that result in material misstatement of the financial statements)*.
We have no knowledge of any fraud or suspected fraud that affects the Company and involves management, employees who have significant roles in internal control, or others where the fraud could have a material effect on the financial statements.	We have no knowledge of any fraud or suspected fraud that affects the Company and involves management, employees who have significant roles in *processing transactions or safeguarding assets*, or others where the fraud could have a material effect on the financial statements.
All material transactions have been recorded in the accounting records and are reflected in the financial statements.	All material transactions have been recorded in the accounting records and are reflected in the financial statements, and *there are no undisclosed assets or liabilities*

Note:

[a] Modifications are italicized for emphasis.

* * *

Those Charged with Governance. AU-C 260, *The Auditor's Communication With Those Charged With Governance,* requires the auditor to provide those individuals with written representations requested from management. AU-C 580.A2 indicates that when those charged with governance have responsibilities in addition to management for the preparation and fair presentation of financial statements, the auditor should also request those individuals to make written representations. There may also be circumstances in which those charged with governance have approved specific major transactions or made oral representations to the auditor concerning those transactions, and the auditor may decide to request written representations on those matters. AU-C 580.A15, for example, describes the following circumstances in which it may be appropriate to obtain written representations from those charged with governance on related party transactions:

- They approved specific related party transactions that (a) are material to the financial statements, or (b) involve management.
- They have made specific representations on details of related party transactions to the auditor.
- They themselves have interests (financial or otherwise) in related parties or transactions with related parties.

The authors believe those charged with governance may also be requested to provide written representations when they, rather than or in addition to management, have authority to establish and approve plans or intentions that may affect the carrying value or classification of assets or liabilities. For example, the accrual for a tax dispute may depend on whether those charged with governance intend to settle or contest the matter.

Those with Specialized Knowledge. AU-C 580.A3 indicates that when there are individuals having specialized knowledge relating to matters about which written representations are requested, the auditor may request management to include in written representations confirmation that it has made inquiries of those individuals. AU-C 580.A4 provides the following examples of such individuals:

- Actuaries who are responsible for actuarially determined accounting measurements.
- Engineers who are responsible for measurement of environmental liabilities.
- Internal legal counsel who are responsible for providing information essential to provisions for legal claims.

AU-C 580.A5 notes that an entity would not be expected to require a formal internal process for obtaining these types of representations beyond those already established.

Materiality Threshold

AU-C 580 permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. AU-C 580.A22 explains limitation is acceptable for representations that directly relate to amounts included in the financial statements if the auditor and management reach an agreement about what is material for this purpose. It would not be acceptable, to limit representations about the completeness of available financial records, management's responsibility for fair presentation, or management's acknowledgment of its responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud. AU-C 580.A22 notes that materiality may be different for different representations, and indicates that an explicit discussion of materiality may be in the representation letter, in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable, but the auditors are discouraged from using a purely quantitative discussion of materiality because it is inappropriate to rely solely on quantitative considerations when determining materiality.

Periods Covered by the Letter

AU-580.20 requires written representations from management who has responsibility for the financial statements and knowledge of the matters concerned for all financial statements and periods covered by the auditor's report. AU-C 580.A26 explains that even when current management was not present during all periods referred to in the auditor's report, current management's responsibilities for the financial statements as a whole are not diminished

and the requirement for the auditor to request from them written representations that cover all the relevant periods still applies. For example, if the auditor is reporting on comparative financial statements, the representation letter for the most recent audit should address all periods being reported on. If senior management changed during or after the period under audit, the auditor still has to insist on written representations from current management.

An AICPA Question and Answer (Q&A 8900.11), *Management Representations Regarding Prior Periods Presented That were Audited by a Predecessor Auditor,* clarifies that the successor auditor does not have to obtain management representations covering the prior period financial statements when: (1) the prior period financial statements were audited by a predecessor auditor, (2) the predecessor auditor's report on the prior period's financial statements is not reissued, and (3) and the successor auditor will not opine on the prior period's financial statements (that is, the successor auditor's report will express an opinion on the current period's financial statements and include an other-matter paragraph regarding the predecessor auditor as required by AU-C 700.55). In that case, the representations are not needed for the prior period because the successor auditor is not opining on the prior period's financial statements. Further representations may be necessary in the current year, however, if the successor auditor finds material misstatements in the prior period's financial statements, and the successor auditor audits the restatement adjustments. Also, a successor auditor may request current period written representations on opening balances, such as prior period internal control deficiencies, consistency in accounting policies, and matters related to report modifications.

Dating of the Letter and Updating Letters

The auditor is concerned with matters occurring through the date of his or her report, not merely through the balance sheet date. As a result, the management representation letter should be dated as of the date of the auditor's report.

There are circumstances that require predecessor auditors to obtain updating representation letters from management. AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, requires a predecessor auditor to obtain a representation letter from management, as well as a representation letter from the successor auditor, before reissuing a report on financial statements of a prior period. This requirement applies when the prior period financial statements are presented on a comparative basis with audited financial statements of a subsequent period. The updating management representation letter should address (a) whether management is aware of any new information that would cause them to believe that any of the previous representations should be modified, and (b) whether any events occurring subsequent to the latest balance sheet date of the financial statements reported on by the predecessor require disclosure in or adjustment to such financial statements.

Receipt of the Letter

AU-C 580.A27 indicates that the auditor does not need to physically possess management's representation letter on the date of the auditor's report. The requirement can be met if on or before the date of the auditor's report management has received the final representation letter and confirmed to the auditor that they will sign the letter without exception. The auditor will need to physically possess the signed letter before releasing the audit report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit often sufficient to preclude an unmodified opinion and may cause an auditor to disclaim or withdraw.

SUBSEQUENT EVENTS REVIEW

Introduction and Authoritative Literature

AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, defines the types of subsequent events the auditor should evaluate and specifies the procedures that should be performed to determine the occurrence of such events. FASB ASC 855-10, *Subsequent Events* includes accounting and disclosure standards on subsequent events.

Objectives and Requirements

The objective of the auditor regarding subsequent events is to obtain sufficient appropriate evidence about whether events occurring after the financial statement date through the date of the auditor's report that require adjustment of or disclosure in, the financial statements are properly reflected in accordance with GAAP (AU-C 560.05).

The requirements that should be followed to achieve that objective are summarized in Exhibit 1-7.

Exhibit 1-7

Requirements for Subsequent Events

Requirements	AU-C Reference
Perform audit procedures to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment of, or disclosure in, the financial statements have been identified.	AU-C 560.09
Perform subsequent events audit procedures covering the period from the date of the financial statements to the date of the auditor's report or as close to that date as practicable.	AU-C 560.10
Take into account the risk assessment when determining the nature and extent of subsequent events audit procedures.	AU-C 560.10
Perform the following audit procedures: • Obtain an understanding of management's procedures to identify subsequent events. • Inquire of management and, when appropriate, those charged with governance about whether any subsequent events have occurred that might affect the financial statements. • Read minutes of the meetings of owners, management, and those charged with governance held after the date of the financial statements and inquire about matters discussed at meetings for which minutes are not yet available. • Read the latest subsequent interim financial statements, if any.	AU-C 560.10
If subsequent events requiring adjustment of, or disclosure in, the financial statements are identified, determine that they are appropriately reflected in accordance with GAAP.	AU-C 560.11

* * *

Dating the Auditor's Report and Subsequent Events Note

FASB ASC 855-10-50-1 requires reporting entities to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or were available to be issued. That disclosure is required regardless of whether the reporting entity recognizes or discloses a subsequent event in its financial statements. Generally, nonpublic entities will evaluate subsequent events through the date that the financial statements are available to be issued, i.e., when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained. Often, this will be the date of the auditor's final conference with the client when proposed adjustments to the financial statements are agreed upon. Therefore, the remainder of this discussion addresses subsequent events in the context of the date the financial statements are available to be issued.

FASB ASC 855-10-20 notes that subsequent events are events or transactions that occur subsequent to the balance sheet date but before financial statements are available to be issued. The period within this time is called the subsequent events period.

The auditor's report is dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion. This includes evidence about subsequent events, so the auditor's report date cannot be earlier than the date of management's subsequent events evaluation note. AU-C 560.A10 notes that, in most cases, the date of management's subsequent events evaluation note will be the same date as the auditor's report. Furthermore, AU-C 580 requires management to make specific representations relating to information

concerning subsequent events, and the date of the management representation letter should be the same as the date of the auditor's report. Therefore, the subsequent evaluation note date, the management representation letter date, and the auditor's report date generally will be the same.

In addition, ordinarily the date of the auditor's report is expected to be close to the report release date. Many firms adopt a policy about when to date their auditor's report if there is a delay in releasing the report (that is, how long of a delay makes it necessary to redate the report). A decision to redate the report should result in extending the subsequent events review to the later date. Auditors may consider covering that matter in their firm's quality control policies and procedures.

Types of Subsequent Events

FASB ASC 855, *Subsequent Events*, prescribes the accounting for subsequent events that are not addressed in other specific accounting standards. For example, FASB ASC 740-10-25-15 prescribes the accounting treatment for changes in judgment after the balance sheet date that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period. When another accounting standard does not prescribe a different treatment, FASB ASC 855-10-20 delineates the two following types of subsequent events:

a. *Recognized Subsequent Events*—The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

b. *Nonrecognized Subsequent Events*—The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date but before the financial statements are available to be issued.

Examples of recognized subsequent events are as follows:

a. Litigation caused by an event that occurred before the balance sheet date, but that was settled for an amount different than the recorded liability before the financial statements were available to be issued. The settlement amount should be considered in estimating the amount of the liability recognized at the balance sheet date.

b. A loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are available to be issued. The effects of the customer's bankruptcy filing should be considered in estimating the amount of uncollectible trade accounts receivable recognized at the balance sheet date.

As a general matter, subsequent events affecting the realization of assets (such as receivables and inventories) or the settlement of estimated liabilities, should be recognized in the financial statements at the balance sheet date when those events represent the culmination of conditions that existed over a relatively long period of time.

Examples of nonrecognized subsequent events are as follows:

a. Sale of a bond or capital stock.

b. Settlement of litigation when the event giving rise to the claim took place after the balance sheet date.

c. Loss of plant or inventories as a result of fire or a natural disaster.

d. Losses on receivables resulting from conditions (such as a customer's major casualty) arising after the balance sheet date.

e. Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates.

f. Entering into significant commitments or contingent liabilities.

g. A business combination.

h. Adoption of a new pension or compensation plan.

i. Loss of or significant changes in insurance coverage that would result in a material uninsured loss.

Subsequent Events Review Procedures

Some subsequent events may be discovered as a result of audit procedures applied for specific financial statement components. These procedures usually involve cutoff tests and assessment of valuation. For example, the inspection of subsequent collections of accounts receivable may disclose a material subsequent event. However, there is a group of procedures performed specifically to search for material subsequent events, the so-called subsequent events review.

According to AU-C 560.10, the auditor should perform subsequent events review procedures that cover the period from the date of the financial statements to the date of the auditor's report or as close to that date as practicable. The subsequent events review procedures generally are:

a. *Understand Management's Procedures.* Auditors should obtain an understanding of procedures management has established to ensure that subsequent events are identified.

b. *Inquire of Management and, When Appropriate, Those Charged with Governance.* The auditor may inquire about the current status of items that were accounted for based on preliminary or inconclusive data and may make specific inquiries related to matters such as the following:

   (1) Developments regarding commitments or contingencies.

   (2) Significant changes in assets or capital structure.

   (3) Existence of unusual adjustments after the balance sheet date.

c. *Evaluate Evidence about Estimates.* The auditor may determine whether events occurring up to the date of the auditor's report provide audit evidence about accounting estimates.

d. *Obtain Lawyer's Letter.* The letter obtained from the client's lawyer, needs to cover matters at the balance sheet date through a period specified in the audit inquiry letter that is as close as possible to the audit report date. (AU-C 501.A53)

e. *Obtain a Management Representation Letter.* The written representations obtained from management, should be as of the audit report date.

f. *Read Minutes of Stockholders' and Directors' Meetings.* The reading of minutes should include those available for meetings after the balance sheet date. If minutes (or drafts) are not available for meetings that occur in the subsequent period, inquiries should be made about significant matters dealt with at those meetings.

g. *Read Internal Financial Reports.* The reading of internal reports generally includes available interim financial statements or budgets. The purpose of this procedure is to identify any significant changes in operations. In a small business, internal financial reports are not extensive, and an auditor needs to discuss with the owner/manager what information is used to monitor operations.

h. *Scan Journals and Ledgers.* The accounting records for the subsequent period may be scanned for unusual items or significant items related to the current period.

i. *Consider Impairment of Assets.* Determine if the carrying amount of assets has become impaired subsequent to year end.

Naturally, additional procedures may be necessary to follow up on material subsequent events discovered in performing the above procedures. If material subsequent events are discovered, auditors should ensure that the workpapers include the information needed to support adjustments to the financial statements or disclosures about subsequent events (AU-C 560.11).

RELATED PARTIES

Introduction and Authoritative Literature

Most business transactions result from bargained dealing. When the parties to a transaction are related, the objectivity expected in unrelated bargaining may be lost. Because of the loss of objectivity, knowledge of the nature and volume of transactions with related parties may be necessary for financial statement users to properly evaluate the company's financial condition and results of operations. Consequently, material related party transactions should be disclosed.

Accounting Standards. The disclosure requirements for related parties are explained in detail in FASB ASC 850, *Related Party Disclosures*. The primary requirements are:

a. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business.

b. The disclosures include the following:

   (1) The nature of the relationship(s). (If necessary to an understanding of the effects of the transactions, the name of the related party should be disclosed.)

   (2) A description of the transactions for each of the periods for which income statements are presented and such other information deemed necessary to understanding the effects of the transactions on the financial statements (including transactions to which no amounts or nominal amounts were ascribed).

   (3) The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.

   (4) Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

   (5) Amounts due from officers, employees, directors, stockholders, or affiliates, and loans or trade receivables held for sale, should be presented separately on the balance sheet.

   (6) Aggregation of similar transactions by type of related party may be appropriate in some cases.

c. If the reporting entity and one or more other entities are under common control and the existence of that control could result in operating results or financial position significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship should be disclosed even if there have been no transactions between the entities.

d. In addition to the disclosures required by FASB ASC 850, guarantees by the entity of debt of related parties may require additional disclosures as a result of FASB ASC 460, such as disclosure of the maximum potential amount payable by the entity.

FASB ASC 850-10-50-5 indicates that representations about related party transactions should not imply that the transactions were consummated on an arm's-length basis unless those representations can be substantiated.

Related parties include affiliates; equity investees; pension, profit-sharing, and similar trusts managed by or under the trusteeship of management; principal owners, management, and members of their immediate families; other parties if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the parties might be prevented from pursuing its own separate interest; or another party that can significantly influence the management or operating policies of the transacting parties or that has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from pursuing its own separate interests.

When a company is directly or indirectly owned or controlled by another company or under common control with another company, related-party considerations usually are of significant concern. When separate financial statements are being audited and presented for subsidiaries, branches and divisions, related party transactions between affiliates are not eliminated as they would be in consolidation. Examples of matters of concern include the following:

- The operations of the subsidiary, branch, or division whose financial statements are being reported on will be subject to influence by the affiliates.
- Transactions among affiliates may involve conflicts of interest or may be recorded according to their form rather than their substance. Examples of transactions that raise questions about their substance include:
  - Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below current market rates.
  - Selling real estate at a price that differs significantly from its appraised value.
  - Exchanging property for similar property in a nonmonetary transaction.
  - Making loans with no scheduled terms about when or how the funds will be repaid.
- Certain income, costs, and expenses common to the affiliates (for example, common management or administrative expenses) may be allocated on an arbitrary basis.

In addition to the disclosures discussed earlier, best practices indicate that the financial statements should disclose (a) information about how corporate expenses are allocated by the parent to the branch or division, and (b) the amount of such corporate expenses allocated.

Auditing Standards. Authoritative literature outlining the auditor's responsibilities relating to related parties and related party transactions is contained in AU-C 550, *Related Parties*.

Objectives and Requirements

The objectives of the auditor regarding related parties are:

a. To obtain an understanding of related party relationships and transactions sufficient to identify fraud risk factors coming from them and conclude whether financial statements affected by them are fairly stated.

b. To obtain sufficient appropriate audit evidence about whether relationships and transactions with related parties have been appropriately identified, accounted for, and disclosed in the financial statements.

The requirements that should be followed to achieve those objectives are summarized in Exhibit 1-8.

Exhibit 1-8

Requirements for Related Parties

Requirements	AU-C Reference
Perform risk assessment procedures to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.	AU-C 550.12
Include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from related party relationships and transactions in the engagement team discussion.	AU-C 550.13
Inquire of management about the following: • Identity of related parties including changes from the prior period. • Nature of the relationships with related parties. • Transactions with related parties during the period and their type and purpose.	AU-C 550.14
Inquire of management and others within the entity and perform other risk assessment procedures to obtain an understanding of the controls to: • Identify, account for, and disclose related party relationships and transactions. • Authorize and approve significant transactions and arrangements with related parties. • Authorize and approve significant transactions and arrangements outside the normal course of business.	AU-C 550.15
Remain alert when inspecting documents or records for arrangements or other information that may indicate the existence of previously unidentified related party relationships or transactions.	AU-C 550.16
Inspect the following for the existence of related party relationships or transactions that management has not identified or disclosed to the auditor: • Bank and legal confirmations. • Minutes of meetings of shareholders and those charged with governance. • Other records or documents considered necessary in the circumstances.	AU-C 550.16
When significant transactions outside the entity's normal course of business are identified, inquire of management about the nature of the transactions and whether related parties could be involved.	AU-C 550.17
Share with other engagement team members the identity of the related parties and other relevant information obtained.	AU-C 550.18
Identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. Treat significant related party transactions outside the normal course of business as significant risks.	AU-C 550.19
When identifying and assessing the risks of material misstatement due to fraud, consider identified fraud risk factors pertaining to related parties.	AU-C 550.20
Design and perform further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions.	AU-C 550.21
If arrangements or other information are identified that suggest the existence of related party relationships or transactions not previously identified or disclosed by management, determine whether the underlying circumstances confirm the existence of those relationships or transactions.	AU-C 550.22

Requirements	AU-C Reference
If related parties or significant related party transactions are identified that management has not previously identified or disclosed: • Communicate the information to other engagement team members. • Request management to identify all transactions with the newly identified related parties. • Inquire why controls over related party relationships and transactions failed to identify or disclose such relationships or transactions. • Perform appropriate substantive audit procedures. • Reconsider the risk that other related parties or significant related party transactions may exist that have not been identified or disclosed and perform additional audit procedures as necessary. • Evaluate the implications for the audit if the nondisclosure by management appears intentional.	AU-C 550.23
For significant related party transactions outside the normal course of business: • Inspect the underlying contracts or agreements and evaluate whether (1) the business rationale (or lack thereof) for the transactions indicates the possibility of fraudulent financial reporting or misappropriation of assets, (2) the terms are consistent with management's explanations, and (3) the transactions have been appropriately accounted for and disclosed. • Obtain audit evidence that the transactions have been appropriately authorized and approved.	AU-C 550.24
Obtain sufficient appropriate audit evidence about any assertion in the financial statements that a related party transaction was conducted on terms equivalent to arm's length.	AU-C 550.25
In forming an opinion on the financial statements, evaluate whether identified related party relationships and transactions have been appropriately accounted for and disclosed and whether their effects prevent the financial statements from being fairly presented.	AU-C 550.26
Communicate significant matters concerning related parties with those charged with governance (unless all of those charged with governance are involved in managing the entity).	AU-C 550.27
Document the names of any identified related parties and the nature of the related party relationships.	AU-C 550.28

* * *

Audit Procedures

The audit procedures for related parties are applied at different times throughout the audit. The timing is generally as follows:

a. At the start of the audit, when performing risk assessment procedures, to identify obvious or known related parties so the auditors can develop appropriate audit procedures and can recognize transactions with those parties when applying other audit procedures.

b. In connection with other audit procedures applied to financial statement components.

c. Near the end of the audit, as a final review, to identify possible undisclosed relationships or transactions and to consider the adequacy of disclosure of identified transactions.

At Start of Audit. The identities of some related parties are known or obvious. For example, principal shareholders, equity investees, parent-subsidiary relationships, and affiliates are usually known and should be communicated to those working on the audit at the start of the engagement. Some of the procedures used at the start of an audit are as follows:

- Inquiry of predecessor auditor to obtain knowledge of known related parties.
- Review of prior years' workpapers to use existing knowledge.
- Discuss with the engagement team the susceptibility of the financial statements to material misstatement due to error or fraud that could result from related party relationships and transactions.
- Inquiry of management to obtain the names of related parties and identify material transactions with them during the period, including any changes from the prior period.
- Inquiry of management and others within the entity to obtain an understanding of the controls over related party relationships and transactions.
- Review of stockholder listings, pension and similar trusts, and investments for relationships that create related parties.
- Reading minutes of stockholders' and directors' meetings to obtain information on material transactions authorized or discussed.
- Review of other documents, such as income tax returns and regulatory filings, to identify related parties and related party transactions.
- Design and perform further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions.

Assessment of the Risk of Material Misstatement Associated with Related Parties. AU-C 550 states that the auditor should—

- Identify and assess the risks of material misstatement associated with related party relationships and transactions.
- Determine whether any of those risks are significant risks.
- Treat significant related party transactions outside the normal course of business as significant risks.
- Obtain an understanding of the controls surrounding related party relationships and transactions.

Best practices indicate that the risk of material misstatement associated with related party relationships and transactions can either be assessed at the financial statement level or the class of transactions, account balance, or disclosure level.

Risks of material misstatement at the financial statement level often relate to risks that are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level.

In Connection with Other Procedures. As audit procedures are applied to specific financial statement components, transactions with known related parties are substantiated and accumulated for disclosure consideration, and other related party transactions may be identified. Most procedures relate to receivables and payables, but some procedures in other areas may produce relevant information. Exhibit 1-9 lists the more common procedures. Occasionally, auditors may discover that the client is settling related party receivables or payables before year end and renewing them after year-end. When auditors encounter such practices, they need to consider whether the settlements of the receivables/payables are accounted for based on their economic substance and whether such transactions are adequately disclosed in the financial statements.

Exhibit 1-9

Additional Related Party Procedures in Conjunction with Other Audit Procedures

Financial Statement Component	Audit Procedure	Information on Related Party Transactions
Cash	Confirmation	Compensating balance or guarantee arrangements for or by related parties.
Cash disbursements	Vouching	Identify and accumulate payments to related parties.
Receivables	Confirmation/Vouching	Separate schedules may be prepared for related party receivables and loans to officers, and trade receivables. Identify guarantors of receivables and determine whether they are related parties.
Payables	Confirmation/Vouching	Payables to related parties may be segregated from trade payables. Terms of related party payables may be confirmed.
Commitments and contingencies	Vouching	Inspection of invoice detail from law firms may indicate related parties.

* * *

The auditor should remain alert when inspecting documents or records for arrangements or other information that may indicate the existence of previously unidentified related party relationships or transactions. Specifically, the auditor should inspect the following for the existence of related party relationships or transactions that management has not identified or disclosed to the auditor:

- Bank and legal confirmations.
- Minutes of meetings of shareholders and those charged with governance.
- Other records or documents considered necessary.

AU-C 550.23 requires the auditor to perform certain procedures when related parties or significant related party transactions are identified that management has not previously identified or disclosed.

Final Review. Generally, the purpose of final review procedures is to evaluate whether there are undisclosed related parties transactions and to evaluate the adequacy of disclosure of identified transactions. Some audit procedures, such as the overall review and final analytical procedures that are performed near the end of the audit, may disclose related party transactions. Generally, those procedures include:

a. Scanning accounting records for large, unusual, or nonrecurring transactions or balances, particularly those around the end of the period.

b. Considering the nature and extent of business with major customers, suppliers, borrowers, or lenders for undisclosed relationships.

c. Considering whether transactions are occurring, but not being given accounting recognition, e.g., a principal owner absorbing business expenses.

Substantiating Material Related Party Transactions. Generally, the audit procedures applied to substantiate material transactions with related parties are the normal procedures applied to other significant transactions, e.g., vouching, confirmation, and recomputation. The auditor could also consider arranging for audits of intercompany account balances at concurrent dates, even if the fiscal years differ, and examination of specified, important, and representative related party transactions by the auditors for each of the parties, with exchange of relevant information. However, an auditor needs to understand the business purpose of material related party transactions and that proper authorization of such transactions, such as by management, the board of directors, or those charged with governance, is more important than for similar transactions with unrelated parties.

If an auditor has identified a significant risk related to the nature, purpose, or recording of such transactions, additional procedures for these circumstances are suggested in AU-C 550.A35, including the following:

a. Confirmation of information, e.g., terms and guarantees, with the other party.

b. Inspection of evidence in possession of the other party.

c. Confirmation or discussion of significant information with intermediaries, such as banks or agents.

d. Reference to financial publications, credit agencies, etc., if there is reason to believe unfamiliar parties, (e.g., customers or suppliers) may lack substance.

e. With respect to material uncollected balances, guarantees, and other obligations, obtaining information about the financial capability of the other party from audited or unaudited financial statements, tax returns, reports issued by regulatory, taxing, or credit agencies, etc.

Other procedures that may be necessary to understand the transaction or obtain evidence about it, include consultation with persons knowledgeable about a particular specialized type of transaction, application of audit procedures at the related party, or even an audit of the related party's financial statements. Additionally, the auditor may consider obtaining representations from senior management and those charged with governance about whether they or any other related parties engaged in any transactions with the company during the period.

When significant transactions outside the entity's normal course of business are identified, the auditor should inquire of management about the nature of the transactions and whether related parties could be involved (AU-C 550.17).

FASB ASC 850 and AU-C 550.25 indicate that representations about related party transactions should not imply that the transactions were consummated on the equivalent of an arm's length basis unless those representations can be substantiated. AU-C 550.A45 notes that generally it is difficult to substantiate management representations that a related party transaction was consummated on an arm's length basis. AU-C 550.A46–.48 provides some example procedures that might be performed to substantiate such representations. If the representations cannot substantiated, the auditor considers the implications for his or her opinion on the financial statements.

Related Party Transactions and Fraud. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider the existence of fraud risk factors when identifying and assessing risks of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate management intentionally misstating the financial statements (for example, selling real estate or other assets to a related party for artificial gain). Appendix A to AU-C 240 lists the following risk factors that may involve transactions with related parties:

- Significant related-party transactions not in the ordinary course of business or with related entities that are unaudited or audited by another firm.

- Significant, unusual, or highly complex transactions (particularly those close to year-end) that are difficult to assess for substance over form.

- Overly complex organizational structure involving unusual legal entities, or lines of managerial authority.

- Difficulty in determining the organization or individual(s) that control the company.

- Significant bank accounts (or subsidiary or branch operations) in tax-haven jurisdictions for which there does not appear to be a clear business justification. [Any time a principal party to a transaction (such as a seller, buyer, lender, or guarantor) is in a tax-haven jurisdiction, the auditor needs to consider the risk of undisclosed related-party transactions.]

Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions. AU-C 550.07 explains that because of the potential for undisclosed related party relationships and transactions, the need for planning and performing the audit with professional skepticism is particularly important. Inspection of records or documents during the audit may indicate the existence of previously unidentified or undisclosed related party relationships or transactions. AU-C 550.A22 provides the following examples of such records or documents:

- Confirmations, including bank and legal confirmations.

- Income tax returns.

- Information supplied to regulatory authorities.

- Shareholder registers.

- Conflict of interest statements from management or those charged with governance.

- Investment records of the entity or its benefit plans.

- Agreements or contracts with those charged with governance or key management personnel.

- Significant new or renegotiated contracts or agreements outside the ordinary course of business.

- Professional advisors' correspondence or invoices.

- Life insurance policies.

- Internal audit reports.

- Financing arrangements with entities other than financial institutions.

- Capital additions through economic development arrangements by another entity.

Certain arrangements made through formal or informal agreements with one or more other parties may also be indicative of unidentified or undisclosed related party relationships or transactions. AU-C 500.A24 provides the following examples:

- Participating in unincorporated partnerships.

- Entering into agreements to provide services to other parties on terms or conditions outside the normal course of business.

- Guarantees or guarantor relationships.

Best practices indicate that the auditor ought to seek information about the other party to the arrangement or agreement and consider the business rationale. AU-C 550.A28 also observes that a related party could be involved in a significant transaction outside the entity's normal course of business by directly or indirectly influencing it through an intermediary.

The additional procedures discussed in earlier in this section may also be performed if the auditor decides to modify his or her procedures based on the consideration of identified fraud risks.

If the auditor's procedures identify arrangements or information that indicates the possible existence of a related party relationship or transaction that was previously unidentified or undisclosed, AU-C 550.22 requires that the auditor determine whether the underlying circumstances confirm their existence. If the auditor's procedures in fact identify such relationships or transactions, the auditor should, according to AU-C 550.23:

- Promptly communicate the information to other engagement team members.
- Have management identify all transactions with newly identified related parties.
- Inquire why controls failed to result in their identification or disclosure.
- Perform appropriate substantive procedures to the newly identified related party relationships and significant transactions.
- Reconsider the risk of other unidentified or undisclosed related party relationships or significant transactions and perform additional audit procedures as necessary.
- Evaluate the implications for other aspects of the audit if management's nondisclosure of the relationships and transactions appear intentional.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Which of the following approaches would require additional effort on the part of the legal counsel when responding to the letter of inquiry?

   a. Short form.

   b. Long form.

5. It is the auditor's responsibility to determine whether the wording of the lawyer's assessment of the probability of an unfavorable outcome is clear regarding a probable or remote outcome. Which of the following is an example of a lawyer's response that is *unclear* on likelihood of outcome?

   a. "We believe the company will be able to defend this action successfully."

   b. "We are of the opinion that this action will not result in any liability to the company."

   c. "It is our opinion that the company will be able to assert meritorious defenses to this action."

   d. "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."

6. Nick verified that the management representation letter from his client contains the appropriate information required by AU-C 580.14. Which of the following information is required by AU-C580.14 to be included in the letter?

   a. Management has considered all the misstatements presented by the auditor and has decided that any uncorrected misstatements are immaterial to the financial statements taken as a whole.

   b. Only uncorrected misstatements identified by the auditor during the audit on the engagement should be included in the management representation letter by the client.

   c. If there are no uncorrected misstatements in the financials, the management representation letter must state this fact.

   d. All uncorrected misstatements must be communicated and detailed in the management representation letter.

7. Auditors suggest using which of the following as a modification of the management representation letter for a small business engagement?

   a. All required communication to the management of the small business is done in writing.

   b. The definition of terms that may not be familiar to a small business owner/manager might be advisable in the management representation letter.

   c. The management representation letter should include information acknowledging the audit adjustments that the auditor made to the financial statements.

   d. Written acknowledgement from the owner/manager of the small business that personal and business accounts are commingled.

8. Which of the following statements regarding the management representation letter is correct?

   a. Current management's responsibilities for the financial statements overall are not reduced if they are not present during all periods referred to in the auditor's report.

   b. A successor auditor is required to obtain management's representations covering the prior period financial statements when the prior period financial statements were audited by a predecessor auditor.

   c. The auditor must receive the management letter by the date of the audit report.

   d. The management representation letter date should coincide with the date of the financial statements.

9. Which of the following accurately illustrates a recognized subsequent event?

   a. Larry is conducting an audit of McClain's Freight Tools Co. McClain's balance sheet date was in May, but in August, a fire broke out in part of the warehouse and about 40% of McClain's inventory was destroyed. Larry was in the process of completing the fieldwork for the audit when the fire occurred.

   b. Bridget is auditing the financial statements of Java Coffee Co. The balance sheet date was March 31, but Bridget discovered that Java's biggest client with the largest outstanding accounts receivable balance is going to file bankruptcy in May. The financial statements have not been issued yet for Java.

   c. Dana is auditing the financial statements of Lanier Exports. The balance sheet date was in January, but Dana discovered that the company has committed to a very large contract to purchase substantial inventory from China in the next month. Dana has just begun her audit work on the client's financials and has not issued them yet.

   d. The value of the assets at Foster International has significantly decreased since the balance sheet date due to the foreign exchange rates. Gerald is currently working on the audit of Foster's financial statements and needs to decide how to handle this information.

10. Debra is conducting an audit of Cunningham Landscapes, a family owned landscaping company. Debra knows of several related party transactions, but wants to make sure she has disclosed them all. Which of the following procedures should be conducted at the start of the audit to identify related parties?

    a. Determine the nature and extent of the business with major customers.

    b. Examine the accounting records for large, unusual or nonrecurring transactions, especially around the end of the period.

    c. Determine if the transactions are happening, but are not being recorded in the financial records.

    d. Analyze prior years' work papers to obtain existing knowledge.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Which of the following approaches would require additional effort on the part of the legal counsel when responding to the letter of inquiry? **(Page 305)**

   a. Short form. [This answer is correct. This approach asks the lawyer to prepare the information rather than comment on management's list, so it would take more time and effort from the legal team. The ABA has expressed a preference for this approach and a client-prepared list is prepared with the lawyer's advice. This approach is usually best suited to a small business engagement.]

   b. Long form. [This answer is incorrect. This approach asks the lawyer to comment on the completeness of information prepared by the client on the details of each case listed as pending or threatened litigation. While this does require effort on the legal team's side, this approach requires less time than another approach used by auditors during an engagement.]

5. It is the auditor's responsibility to determine whether the wording of the lawyer's assessment of the probability of an unfavorable outcome is clear regarding a probable or remote outcome. Which of the following is an example of a lawyer's response that is *unclear* on likelihood of outcome? **(Page 307)**

   a. "We believe the company will be able to defend this action successfully." [This answer is incorrect. This response clearly indicates that an unfavorable outcome is remote according to the guidance in AU-C 501.A65.]

   b. "We are of the opinion that this action will not result in any liability to the company." [This answer is incorrect. According to AU-C 501.A65, this response clearly indicates an unfavorable outcome is remote.]

   c. "It is our opinion that the company will be able to assert meritorious defenses to this action." [This answer is correct. According to the guidance in AU-C 501.A65, this response is unclear on likelihood of outcome.]

   d. "It is our opinion that the possible liability to the company in this proceeding is nominal in amount." [This answer is incorrect. According to the guidance in AU-C 501.A65, this response indicates an unfavorable outcome is remote.]

6. Nick verified that the management representation letter from his client contains the appropriate information required by AU-C 580.14. Which of the following information is required by AU-C580.14 to be included in the letter? **(Page 315)**

   a. Management has considered all the misstatements presented by the auditor and has decided that any uncorrected misstatements are immaterial to the financial statements taken as a whole. [This answer is correct. AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.]

   b. Only uncorrected misstatements identified by the auditor during the audit on the engagement should be included in the management representation letter by the client. [This answer is incorrect. Uncorrected misstatements communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor's attention by management.]

   c. If there are no uncorrected misstatements in the financials, the management representation letter must state this fact. [This answer is incorrect. Authoritative literature does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation, (that is, when either no

misstatements are noted in the audit or all noted misstatements are corrected), best practices indicate no representation about uncorrected misstatements is necessary in the management representation letter.]

d. All uncorrected misstatements must be communicated and detailed in the management representation letter. [This answer is incorrect. Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences. Those misstatements (often referred to as trivial misstatements or differences passed at the workpaper level) need not be included in the summary of uncorrected misstatements communicated in the management representation letter.]

7. Auditors suggest using which of the following as a modification of the management representation letter for a small business engagement? **(Page 317)**

a. All required communication to the management of the small business is done in writing. [This answer is incorrect. Oral communication is permitted in certain circumstances under AU-C 260, but if required communications are orally reported, it is desirable for the owner/manager to acknowledge in the representation letter that the matters have been reported.]

b. The definition of terms that may not be familiar to a small business owner/manager might be advisable in the management representation letter. [This answer is correct. In a small business engagement, it may be advisable to modify some of the standard wording to define technical terms that may not be familiar to a small business owner/manager and, in general, to make the owner/manager more comfortable with the reasonableness of the representations being requested.]

c. The management representation letter should include information acknowledging the audit adjustments that the auditor made to the financial statements. [This answer is incorrect. A modification for a small business' management representation letter is to obtain management's acknowledgement of responsibility for audit adjustments booked by the client, not the auditor.]

d. Written acknowledgement from the owner/manager of the small business that personal and business accounts are commingled. [This answer is incorrect. Small businesses often have informal recordkeeping systems, and it is easy to commingle personal and business transactions. Thus, it is beneficial to have the owner/manager acknowledge that the accounts do not contain personal transactions.]

8. Which of the following statements regarding the management representation letter is correct? **(Page 318)**

a. Current management's responsibilities for the financial statements overall are not reduced if they are not present during all periods referred to in the auditor's report. [This answer is correct. According to AU-C 580.A26, even when current management was not present during all periods referred to in the auditor's report, current management's responsibilities for the financial statements as a whole are not diminished and the requirement for the auditor to request from them written representations that cover all the relevant periods still applies.]

b. A successor auditor is required to obtain management's representations covering the prior period financial statements when the prior period financial statements were audited by a predecessor auditor. [This answer is incorrect. An AICPA Question and Answer, *Management Representations Regarding Prior Periods Presented That were Audited by a Predecessor Auditor,* clarifies that the successor auditor does not have to obtain management representations covering the prior period financial statements when: (1) the prior period financial statements were audited by a predecessor auditor, (2) the predecessor auditor's report on the prior period's financial statements is not reissued, and (3) and the successor auditor will not opine on the prior period's financial statements.]

c. The auditor must receive the management letter by the date of the audit report. [This answer is incorrect. AU-C 580.A27 indicates that the auditor does not need to physically possess management's representation letter on the date of the auditor's report. However, the auditor must physically possess the signed letter before releasing the report.]

d. The management representation letter date should coincide with the date of the financial statements. [This answer is incorrect. The auditor is concerned with matters occurring through the date of his or her report,

not merely through the balance sheet date. As a result, the management representation letter should be dated as of the date of the auditor's report.]

9. Which of the following accurately illustrates a recognized subsequent event? **(Page 322)**

   a. Larry is conducting an audit of McClain's Freight Tools Co. McClain's balance sheet date was in May, but in August, a fire broke out in part of the warehouse and about 40% of McClain's inventory was destroyed. Larry was in the process of completing the fieldwork for the audit when the fire occurred. [This answer is incorrect. According to FASB ASC 855-10-20, a nonrecognized subsequent event is one that provides evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date but before the financial statements are issued or available to be issued. An example of a nonrecognized subsequent event is the loss of plant or inventories as a result of fire or a natural disaster.]

   b. Bridget is auditing the financial statements of Java Coffee Co. The balance sheet date was March 31, but Bridget discovered that Java's biggest client with the largest outstanding accounts receivable balance is going to file bankruptcy in May. The financial statements have not been issued yet for Java. [This answer is correct. A loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are available to be issued according to FASB ASC 855-10-20. The effects of the customer's bankruptcy filing should be considered in estimating the amount of uncollectible trade accounts receivable recognized at the balance sheet date.]

   c. Dana is auditing the financial statements of Lanier Exports. The balance sheet date was in January, but Dana discovered that the company has committed to a very large contract to purchase substantial inventory from China in the next month. Dana has just begun her audit work on the client's financials and has not issued them yet. [This answer is incorrect. An example of a nonrecognized subsequent event is if a company entered into significant commitments or contingent liabilities after the balance sheet date, but before the financial statements are issued. This subsequent event would be nonrecognized.]

   d. The value of the assets at Foster International has significantly decreased since the balance sheet date due to the foreign exchange rates. Gerald is currently working on the audit of Foster's financial statements and needs to decide how to handle this information. [This answer is incorrect. Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates are examples of a nonrecognized subsequent event and should not be recognized in the financial statements according to FASB ASC 855-10-20.]

10. Debra is conducting an audit of Cunningham Landscapes, a family owned landscaping company. Debra knows of several related party transactions, but wants to make sure she has disclosed them all. Which of the following procedures should be conducted at the start of the audit to identify related parties? **(Page 328)**

    a. Determine the nature and extent of the business with major customers. [This answer is incorrect. Considering the nature and extent of business with major customers, suppliers, borrowers, or lenders for undisclosed relationships is a procedure that an auditor would do in the final review stages of an audit to evaluate whether there are undisclosed related party transactions.]

    b. Examine the accounting records for large, unusual or nonrecurring transactions, especially around the end of the period. [This answer is incorrect. An auditor would scan accounting records for large, unusual or nonrecurring transactions or balances, particularly those around the end of the period during the final review stage of an audit.]

    c. Determine if the transactions are happening, but are not being recorded in the financial records. [This answer is incorrect. Considering whether transactions are occurring, but not being given accounting recognition is a procedure that an auditor would do in the final review stages of an audit.]

    d. Analyze prior years' work papers to obtain existing knowledge. [This answer is correct. There are some additional procedures that an auditor can do at the start of an audit to identify related parties. One example would be to review the prior years' workpapers.]

GOING CONCERN CONSIDERATIONS

Introduction and Authoritative Literature

FASB ASC 205-40, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related disclosures. The key features of FASB ASC 205-40 are as follows:

- Defines the term *substantial doubt*.
- Requires management to evaluate whether conditions and events raise substantial doubt at both interim and annual period ends.
- Requires management's evaluation to be based on an assessment of the effect of known and reasonably knowable conditions and events at the date the financial statements are available to be issued for a period one year after that date.
- Identifies principles for considering whether management's plans mitigate the substantial doubt.
- Requires certain disclosures when consideration of management's plans alleviates substantial doubt.
- Requires an explicit statement by management that there is substantial doubt as well as other disclosures when substantial doubt is not alleviated.

SAS No. 132 (AU-C 570), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* explicitly recognizes management's responsibility to consider going concern issues under GAAP and premises the auditor's procedures on that responsibility. It also clarifies the applicability of the standard when the financial statements are based on a financial reporting framework other than GAAP.

Objectives and Requirements

The auditor's objectives under AU-C 570 are as follows:

- To obtain sufficient and appropriate audit evidence about and conclude on the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements.
- To conclude on whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists, based on the audit evidence obtained.
- To evaluate possible effects on the financial statements, such as the adequacy of disclosure regarding an entity's ability to continue as a going concern for a reasonable period of time.
- To issue an auditor's report in accordance with the auditing standard.

AU-C 570 defines *reasonable period of time* as the period required by the applicable financial reporting framework, or, if no such period is designated, one year from the date the financial statements are available to be issued. This brings the lookout period under the auditing standards into line with the period defined by GAAP in FASB ASC 205-40.

The requirements that should be followed to achieve those objectives are summarized in Exhibit 1-10.

Exhibit 1-10

Requirements for Evaluating and Reporting on Going-Concern Uncertainties

Requirements	AU-C Reference
Risk Assessment Procedures and Related Activities	
When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, consider if there are conditions or events (considered in the aggregate) that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	AU-C 570.12
As part of the performance of risk assessment procedures, determine if management has performed a preliminary evaluation of whether conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time exist: • If so, discuss the evaluation with management and determine if conditions or events have been identified and, if so, understand management's plans to address such matters. • If not, discuss with management the basis for the planned use of the going concern basis of accounting and if conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	AU-C 570.12
Remain alert throughout the audit for any evidence of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.	AU-C 570.13
The Auditor's Evaluation and Management's Evaluation	
The auditor's evaluation should— • Address management's evaluation of whether aggregate conditions or events exist that raise substantial doubt about going concern • Cover the same period that was used by management in its evaluation as required by the applicable financial reporting framework. • Consider whether management's evaluation includes all appropriate information that the auditor is aware of during the audit.	AU-C 570.14
Period beyond the Evaluation Period	
Inquire of management about its knowledge of conditions or events beyond the management evaluation period that could have an effect on the entity's ability to continue as a going concern.	AU-C 570.15
Additional Procedures When There are Identified Conditions or Events	
Obtain sufficient appropriate audit evidence by performing additional audit procedures in order to determine if identified aggregate conditions or events raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, including the consideration of mitigating factors; such procedures include: • Asking management to perform an evaluation when it has not done so. • Evaluating management's plans which relate to the evaluation as to whether it is probable that they (a) can be effectively implemented, and (b) would mitigate the identified conditions or events. • If a cash forecast has been prepared and is a significant factor in evaluating management's plans, (a) evaluating the reliability of the underlying data used to prepare the forecast, and (b) determining whether adequate support exists for the forecast assumptions (including the consideration of contradictory evidence). • Considering if other facts or information has become available after the date of management's evaluation.	AU-C 570.16

Requirements	AU-C Reference
If management's plans include financial support by third parties or the entity's owner-manager that is necessary to continue as a going concern, obtain sufficient appropriate audit evidence about (a) the intent of the supporting parties (in writing) to provide the support, (b) the ability of the parties to provide the support. (Failure to obtain written evidence about intent results in a conclusion that management's plans are insufficient to alleviate a determination that substantial doubt exists about the entity's ability to continue as a going concern.)	AU-C 570.17
Written Representations	
When the auditor believes before consideration of management's plans that substantial doubt exists about an entity's ability to continue as a going concern, request management's written representations.	AU-C 570.18
Auditor Conclusions	
Evaluate whether sufficient appropriate audit evidence has been obtained and conclude on the appropriateness of management's use of the going concern basis of accounting, when preparing the financial statements, when relevant.	AU-C 570.19
Conclude, based on audit evidence obtained, on whether there are aggregate conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	AU-C 570.20
When the auditor concludes that the use of the going concern basis of accounting is appropriate by management but substantial doubt about the ability to continue as going concern exists, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.	AU-C 570.21
When aggregate conditions or events have been identified and, based on audit evidence obtained, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern has been alleviated, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.	AU-C 570.22
The Auditor's Report[a]	
When the financial statements have been prepared using the going concern basis of accounting, but the auditor believes the basis is inappropriate, express an adverse opinion.	AU-C 570.23
Include an emphasis-of-matter paragraph when the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains after considering identified conditions or events and management's plans.	AU-C 570.24
When expressing an emphasis-of-matter paragraph about the entity's ability to continue as a going concern, use terms consistent with the applicable financial reporting framework. (Do not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as a going concern.)	AU-C 570.25
If there is inadequate disclosure about the entity's ability to continue as a going concern, express a qualified or adverse opinion, as appropriate, in accordance with AU-C 705.	AU-C 570.26
In situations where management is unwilling to perform or extend its evaluation to meet the required time period under the applicable financial reporting framework, consider the implications on the auditor's report.	AU-C 570.27

Requirements	AU-C Reference
Communication with Those Charged with Governance	
Unless all those charged with governance also are managing the entity, communicate the following matters to those charged with governance about the aggregate conditions and events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time: • Whether the aggregate conditions or events constitute substantial doubt. • The auditor's consideration of management's plans. • The appropriateness of management's use of the going concern basis of accounting, when relevant, in preparing the financial statements. • Whether the related disclosures in the financial statements are adequate. • Implications for the auditor's report.	AU-C 570.28
Documentation	
If there are identified aggregate conditions or events that raise substantial doubt about the entity's ability to continue as a going concern before the consideration of management's plans, document specified matters.	AU-C 570.32
Comparative Presentations	
In comparative presentations, do not repeat the prior year emphasis-of-matter paragraph if substantial doubt has been removed in the current period.	AU-C 570.29
Eliminating an Emphasis-of-Matter Paragraph from a Reissued Report	
Reassess the entity's going concern status if requested to reissue a report and eliminate a going concern emphasis-of-matter paragraph.	AU-C 570.30
Significant Delays	
When there is a significant delay in the issuance of financial statements, inquire as to the reason. If the delay appears to relate to the evaluation of whether there is substantial doubt about the entity's ability to continue as a going concern, perform necessary additional audit procedures and consider the effect on the auditor's conclusion about the existence of substantial doubt.	AU-C 570.31

Note:

[a] The 2017 edition of *PPC's Guide to Auditor's Reports* provides illustrations of auditor's reports relating to going-concern considerations.

* * *

Risk Assessment Procedures and Related Activities

AU-C 570 was modeled by the AICPA after the IAASB's International Standard for Auditing, which includes going-concern procedures early in the audit process. Accordingly, AU-C 570 includes procedures for auditors to perform in the planning and risk assessment phases of the audit. AU-C 570.12 requires that the auditor consider, when performing risk assessment procedures as discussed in AU-C 315, whether there are aggregate conditions or events that raise doubt about the entity's ability to continue as a going concern for a reasonable period of time. As part of risk assessment procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events have been identified. If so, auditors and management discuss management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, as well as plans to address any issues identified. If management has not yet made such an evaluation, the auditor has to discuss with management why management intends to use the going-concern basis and inquire as to any existing conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. Auditors should consider management's evaluation in the risk assessment process and remain alert throughout the audit for any evidence indicating conditions or events that raise substantial doubt regarding going concern.

Outside of the requirements for inquiry and discussion with management regarding its evaluation of aggregate conditions or events, AU-C 570 does not specify any other specific risk assessment procedures designed to search for conditions or events that might affect the entity's ability to continue as a going concern. The authors believe that the following are examples of customary auditing procedures that might provide evidence about such conditions and events:

a. Applying analytical procedures.

b. Reviewing subsequent events.

c. Reviewing compliance with the terms of debt and loan agreements, particularly debt maturing in the near term.

d. Reading the minutes of meetings of stockholders, board of directors, and other important committees.

e. Inquiring of an entity's legal counsel about litigation, claims, and assessments.

f. Confirming with related and third parties the details of arrangements to provide or maintain financial support.

g. Reviewing and considering significant events and transactions, such as termination of major proposed transactions, disposal of significant facilities, discontinuance of operations of a segment, or loss of a major customer, license, supplier, franchise, or market.

h. Reviewing correspondence with banks concerning credit lines and similar commitments.

AU-C 570.A7 notes, similar to FASB ASC 205-40, that an entity should determine the likelihood and magnitude of the potential effects of conditions and events that can raise substantial doubt about an entity's ability to continue as a going concern, along with the consideration of the timing. AU-C 570.A7 provides the following examples of such conditions or events:

a. Negative trends.

   (1) Recurring operating losses.

   (2) Working capital deficiencies.

   (3) Negative cash flows from operating activities.

   (4) Adverse key financial ratios.

b. Other indications of possible financial difficulties.

   (1) Default on loan or similar agreements.

   (2) Arrearages in dividends.

   (3) Denial of usual trade credit from suppliers.

   (4) Restructuring of debt.

   (5) Need to seek new sources or methods of financing.

   (6) Need to dispose of substantial assets.

c. Internal matters.

(1) Work stoppages or other labor difficulties.

(2) Substantial dependence on the success of a particular project.

(3) Uneconomic long-term commitments.

(4) Need to significantly revise operations.

d. External matters that have occurred.

(1) Legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate.

(2) Losing a key franchise, license, or patent.

(3) Losing a principal customer or supplier.

(4) Uninsured or underinsured catastrophe such as drought, earthquake, or flood.

If necessary, the auditor needs to obtain additional information about any conditions and events identified.

The Auditor's Evaluation

AU-C 570 requires the auditor's evaluation to address management's evaluation of the entity's ability to continue as a going concern, consider the same time period as management's evaluation, and consider whether management has considered all relevant information of which the auditor is aware when making management's evaluation. The auditor's evaluation of management's evaluation of whether there is substantial doubt might include a review of the process that management used, the assumptions employed, management's plans, and whether the plans are feasible in the circumstances.

Periods Beyond the Evaluation Period

AU-C 570.15 notes that the auditor should inquire if management has any knowledge of conditions or events beyond the management evaluation period that could affect the entity's ability to continue as a going concern. Besides that inquiry, no additional procedures are required for the identification of additional conditions or events that may raise substantial about the entity's ability to continue as a going concern beyond the period evaluated by management. AU-C 570.A27 notes that knowledge of conditions or events beyond the one year evaluation period would not affect the evaluation of whether substantial doubt exists, but may affect other disclosure requirements or a consideration of whether financial statements are fairly presented.

Audit Procedures

To obtain sufficient, appropriate audit evidence about whether conditions and events identified and considered in the aggregate raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, AU-C 570.16 states that the auditor should perform the following procedures:

- Request that management perform an evaluation if they have not yet done so.
- Evaluate management's plans in relation to its going concern evaluation, considering whether it is probable that the plans can be effectively implemented, and whether the plans would mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.
- If a cash forecast relevant to management's plans has been prepared, evaluate the reliability of the underlying data generated to prepare it and determine whether there is adequate support for the underlying assumptions. This includes considering contradictory audit evidence, such as assumptions in the cash flow forecasts that are inconsistent with those used for other purposes like impairment or deferred tax asset analysis.
- Consider any facts or information that have become available since the date of management's evaluation.

AU-C 570.A20 notes that the auditor has no responsibility to rectify any lack of analysis by management to support its evaluation. The auditor may, however, be able to conclude whether substantial doubt exists even when management has not performed a detailed analysis. For example, management may have not performed a detailed analysis to support its evaluation if the entity has a history of profitable operations and readily available financial resources. In this situation, the auditor may not need to perform detailed evaluation procedures of the appropriateness of management's evaluation if the auditor's other audit procedures allow the auditor to conclude whether there is substantial doubt in the circumstances. In situations where the applicable financial reporting framework requires management to make an evaluation, such as under FASB ASC 205-40, the lack of a detailed analysis by management might be considered as an indicator of an internal control deficiency as discussed in AUC 265.

Other Relevant Procedures. AU-C 570.A28 provides examples of procedures that might be relevant to obtaining sufficient appropriate audit evidence whether identified conditions or events raise substantial doubt about the entity's ability to continue as a going concern as follows:

- Analyze and discuss with management relevant forecasts such as cash flow, profit, or others.
- Analyze and discuss the most recently available interim financial statements.
- Read debenture and loan agreements and determine whether any terms have been breached.
- Read minutes of meetings of stockholders, those charged with governance, and relevant committees, to identify indications of financial difficulties.
- Inquire of legal counsel about litigation and claims and the reasonableness of management's evaluation of the outcome and estimates.
- Evaluate management's plans to deal with open customer orders.
- Confirm with lenders the existence and terms of borrowing facilities and evaluate their adequacy.
- Obtain and review reports of regulatory actions.
- Obtain support for any planned disposals of assets and determine its adequacy.

Management's Plans. The significance of identified conditions or events may be mitigated by certain plans of management that are probable of implementation and would be effective in overcoming the adverse effects of such conditions or events. AU-C 570.A8 provides examples of management plans that might be implemented and the information that should be considered when evaluating the plan's feasibility and probability of effective implementation within one year after the date the financial statements are available to be issued. These examples are as follows:

a. Plans to dispose of an asset or business.

   (1) Restrictions on disposal of an asset or business, such as covenants in loan or similar agreements that limit asset dispositions or other encumberances.

   (2) Marketability of assets that management plans to sell.

   (3) Possible direct or indirect effects of disposal of the asset or business.

b. Plans to borrow money or restructure debt.

   (1) Availability and terms of new debt financing or existing debt refinancing, such as lines of credit, arrangements for factoring receivables, or sale-leaseback agreements.

   (2) Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity.

   (3) Possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral.

c. Plans to borrow money or restructure debt.

(1) Feasibility of plans to reduce overhead or administrative costs, to postpone maintenance or research and development projects, or to lease rather than purchase assets.

(2) Possible direct or indirect effects of reduced or delayed expenditures.

d. Plans to borrow money or restructure debt.

(1) Feasibility of plans to increase ownership equity, including existing agreements or commitments to raise capital.

(2) Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors.

The auditor should consider the need to obtain additional evidential matter about management plans (including any available prospective financial statements) and exercise an appropriate level of professional skepticism.

When a cash flow forecast or prospective financial information is a significant factor in the evaluation of management's plans, in addition to the matters discussed earlier in this section regarding the reliability of underlying data and adequate support for assumptions, AU-C 570.A30 notes that the auditor might compare prior prospective financial information to historical actual results, as well as the comparison of current prospective information with actual results to date.

Management's plans may include financial support by third parties or the entity's owner(s) or manager(s), referred to as *supporting parties* in AU-C 570. If funding from supporting parties provides a basis for management's assertion that the entity has the ability to continue as a going concern, AU-C 570 states that the auditor should obtain sufficient appropriate audit evidence on the intent and ability of the supporting parties to provide the necessary financial support. This includes gathering written evidence of the supporting parties' intent, which may be in the form of a documented commitment from the supporting party (commonly referred to as a "support letter") obtained from management or a written confirmation obtained directly by the auditor. If a supporting party is an owner/manager, a written management representation may serve as evidence of intent. A copy of the written evidence ought to be maintained in the audit documentation. When examining this evidence, consider whether arrangements made with supporting parties are legal and enforceable. (See AU-C 570.A32.) Any written support letter or confirmation ought to define a specific date through which the supporting party intends to provide support; for example, a year and a day from the date the financial statements are available to be issued. AU-C 570.A36 provides an illustration of a third-party support letter. Among other things, examples of evidence of supporting parties' ability to provide funding may include evidence of past support obtained from the parties, or evaluation of the parties' solvency via analysis of their financial statements.

Auditor's Conclusions

AU-C 570 requires the auditor to make the following conclusions:

- Evaluate whether sufficient appropriate audit evidence has been obtained and conclude on the appropriateness of management's use of the going concern basis of accounting, when preparing the financial statements, when relevant.

- Conclude, based on audit evidence obtained, on whether there are aggregate conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

- When the auditor concludes that the use of the going concern basis of accounting is appropriate by management, but substantial doubt about the ability to continue as going concern exists, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.

- When aggregate conditions or events have been identified and, based on audit evidence obtained, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern has been

alleviated, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.

When considering the adequacy of the disclosures under GAAP, the auditor will look to the requirements in FASB ASC 205-40-50.

Reporting Considerations

Guidance for reporting under AU-C 570 is provided in *PPC's Guide to Auditor's* Reports.

Management's Representations

AU-C 570.18 requires the auditor to obtain written representations from management if conditions and events indicate there is substantial doubt about the entity's ability to continue as a going concern. Representations are required even if the auditor concludes, based on evaluation of management's plans, that substantial doubt is alleviated.

Communicating with Those Charged with Governance

AU-C 570.28 requires certain communications with those charged with governance unless all are involved in managing the entity.

Significant Delays in Issuing the Financial Statements

SAS No. 132 AU-C 570 addresses situations where management or those charged with governance significantly delay the expected issuance of the financial statements. In such situations, the auditor is required to make inquiries about the reasons for the delay. If the auditor suspects that the delay relates to the evaluation of substantial doubt regarding going concern, additional procedures should be performed, such as those listed earlier. Furthermore, the auditor should reconsider his or her conclusion about substantial doubt as to the entity's ability to continue as a going concern.

Documentation Requirements

When conditions or events cause the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time before the consideration of management plans, AU-C 570.32 requires documentation of the following:

- The conditions or events.
- Significant elements of management's plans to overcoming the conditions or events, per the auditor's judgment.
- Audit procedures performed in evaluating significant elements of management's plans and the evidence obtained, where applicable.
- The auditor's conclusion regarding whether substantial doubt continues to exist or is alleviated.
- When substantial doubt remains, the possible effects of the conditions or events on the financial statements and the adequacy of disclosures.
- When substantial doubt is alleviated, the auditor's conclusion about the need for and the adequacy of disclosures about the principal conditions or events that originally created substantial doubt and management's plans that alleviated it.
- The author's conclusion concerning the effects on the auditor's report.

The authors recommend that auditors use a generalized audit program step or checklist to document going concern considerations. This will ensure that the assessment will be made on every audit.

Reissued Reports Eliminating a Going-Concern Uncertainty Paragraph

AU-C 570.30 addresses situations where management asks the auditor to reissue an auditor's report and eliminate the going-concern emphasis-of-matter paragraph. When determining whether to reissue the report to eliminate the going concern emphasis-of-matter paragraph, AU-C 570.30 indicates that the auditor should reassess the going concern status of the entity by doing the following:

- Perform audit procedures on the event or transaction that resulted in the entity's request to reissue the report without a going concern emphasis-of-matter paragraph.
- Update his or her subsequent events review through the reissuance date.
- Reconsider the conditions, events, and matters discussed earlier in this section at the date of reissuance.
- Consider the implications for the auditor's report. As part of updating the subsequent events review, the auditor should perform procedures to evaluate whether the financial statement disclosures concerning management's plans which mitigate the previously-raised substantial doubt about the entity's ability to continue as a going concern are adequate.

Interim Financial Statements

AU-C 930, *Interim Financial Information*, requires review procedures to address the situations when the applicable financial reporting framework requires management to evaluate the entity's ability to continue as a going concern in preparing interim financial information. Review procedures are required if the applicable financial reporting framework does not require management to evaluate the entity's ability to continue as a going concern, but there are conditions or events that raise a substantial doubt. An emphasis-of-matter paragraph has to be added to the auditor's report on interim financial information when substantial doubt exists about the entity's ability to continue as a going concern.

RISKS AND UNCERTAINTIES

In general terms, uncertainty stems from the inability to predict the future, and risks exist because uncertainty exists. FASB ASC 275, *Risks and Uncertainties*, requires—

- Disclosure of risks and uncertainties that could significantly affect the amounts reported in the financial statements or the near-term functioning of the company.
- Communication to financial statement users of the inherent limitations in financial statements.

GAAP attempts to accomplish this purpose not by requiring disclosure of all risks and uncertainties, which would be an impossible task, but by requiring disclosure of certain risks and uncertainties that meet specified criteria. Disclosure is required in the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Current vulnerability due to certain concentrations.

The first two disclosures, nature of operations and use of estimates, are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria.

Scope and Applicability

FASB ASC 275 applies regardless of the entity's size, and it applies to both public and nonpublic companies. It does not apply to condensed or summarized interim financial statements. FASB ASC 275 states that it applies to

financial statements prepared in conformity with GAAP applicable to nongovernmental entities. However, the issue relating to applicability of FASB ASC 275 to financial statements prepared on a special purpose framework is not quite that clear cut, as discussed in the following paragraphs.

Financial Statements Prepared on a Special Purpose Framework. GAAP does not address the applicability of the risks and uncertainties disclosure requirements to financial statements prepared on a special purpose framework, such as the cash or tax basis of accounting. Absent any such guidance in GAAP, the only authoritative literature on the subject is AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*. AU-C 800.17 requires the auditor to evaluate whether the financial statements include informative disclosures similar to those required by GAAP where the special purpose financial statements contain items that are the same as, or similar to, those in GAAP financial statements. AU-C 800 further requires the auditor to evaluate whether additional disclosures related to matters not specifically identified on the face of the financial statements or other disclosures are necessary for fair presentation of the financial statements. AU-C 800.A22 notes that such disclosures may include significant uncertainties. If necessary for fair presentation, the special purpose financial statements would include the same disclosure required by GAAP or a disclosure that communicates the substance of those requirements. AU-C 800 also indicates that regardless of whether the going concern basis of accounting is relevant to the special purpose financial statements, the requirements in AU-C 570 apply regarding (a) the conclusion on whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, and (b) the evaluation of the financial statement effects, as well as the adequacy of related disclosures, regarding going concern matters.

As a practical matter, the nature of a company's business may already be disclosed in many financial statements prepared on a special purpose framework, as may economic dependence (which in many cases will satisfy the requirements for disclosure of concentrations). That leaves only the disclosures related to estimates—use of estimates and certain significant estimates. Often, preparation of special purpose framework financial statements may not require significant estimates. Consequently, FASB ASC 275 may have little or no effect on many special purpose framework financial statements. However, the applicability of the guidance and the need for its disclosures is determined on a case-by-case basis, based on the facts and circumstances in each individual engagement.

Excluded Items. Certain risks and uncertainties are explicitly excluded from the disclosure requirements of FASB ASC 275. These include risks and uncertainties that might be associated with the following:

- Management or key personnel (for example, loss of the owner/manager of a small business).
- Proposed changes in government regulations.
- Proposed changes in accounting principles.
- Deficiencies in a company's internal control.
- Acts of God.
- War.
- Sudden catastrophes.

Disclosures about Risks and Uncertainties

Nature of Operations. All financial statements should include a description of the major products or services the reporting entity sells or provides and the entity's principal markets, including the locations of those markets. Finally, if the entity operates in more than one business, disclosures must indicate the relative importance of each business and the basis for determining relative importance. If all or most of a company's sales are credit sales, disclosures about concentrations of credit risk required by FASB ASC 825 may also accomplish the disclosure of the company's principal markets.

Use of Estimates. FASB ASC 275 requires financial statement disclosures to include an explanation that preparation of financial statements requires the use of management's estimates and acknowledges that the disclosure will

usually be standardized (that is, boilerplate). The disclosure normally should be included in the summary of significant accounting policies.

Certain Significant Estimates. FASB ASC 275 requires additional disclosures for certain *significant* estimates when the estimate meets both of the following criteria:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events, and
- the effect of the change would be material to the financial statements.

Near term means within a period of time not to exceed one year from the date of the financial statements.

This does not mean that the auditor is expected to predict future events. Essentially, disclosure is required when (a) the condition requiring the estimate existed at the date of the financial statements, and (b) it is known to be at least reasonably possible that the estimate may change by a material amount due to future events.

Current Vulnerability Due to Concentrations. FASB ASC 275 also requires disclosure of concentrations that meet certain criteria. The types of concentrations that should be *considered* for disclosure are as follows:

- Concentrations in the volume of business transacted with a particular customer, supplier, or lender.
- Concentrations in revenue from particular products or services.
- Concentrations in the available sources of supply of materials, labor, or services; or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographic area in which an entity conducts its operations.

The guidance does not specifically define *concentration*. It merely states that vulnerability from concentrations occurs when an entity is exposed to a greater risk of loss than would have existed if the entity had mitigated its risk through diversification. A concentration is of concern when it involves something that cannot be easily replaced, such as the sole domestic supplier of a raw material critical to the company's production process. Concentrations may involve another entity or individual, or they may involve a group of counterparties or items that have similar economic characteristics, such as a group of customers that collectively expose the reporting entity to a particular kind of risk.

Disclosure of concentrations is required only if *all* of the following criteria are met:

- The concentration exists at the date of the financial statements (the balance sheet date).
- The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

Individual owner/managers play a critical role in the success and viability of many small businesses. The loss of such an owner/manager would in many cases have a severe impact on the business. However, disclosure of the risks and uncertainties associated with management or key personnel is not required.

Summary of Disclosure Requirements. Exhibit 1-11 summarizes the disclosure requirements of FASB ASC 275. Definitions of certain terms discussed previously and italicized in the exhibit follow:

- *Reasonably Possible.* FASB ASC 275 states that the term *reasonably possible* is used consistently with its use in FASB ASC 450. The FASB ASC Master Glossary provides the following definitions:
  - *Probable.* "The future event or events are likely to occur."

- *Reasonably Possible.* "The chance of the future event or events occurring is more than remote but less than likely."

- *Remote.* "The chance of the future event or events occurring is slight."

Consequently, reasonably possible means anything more than remote but less than probable. FASB ASC 275 uses the phrase *at least* reasonably possible, which means anything more than remote, or slight.

- *Near Term.* This term is defined in FASB ASC 275 as "a period of time not to exceed one year from the date of the financial statements."

- *Material.* FASB ASC 275 indicates that materiality for disclosure does not depend on the amount reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have on the financial statements. Therefore, disclosure may be required even if an estimate resulted in the recognition of a small financial statement amount, or no amount. When evaluating the potential materiality of a change in an estimate, auditors would use the same materiality thresholds used to evaluate uncorrected misstatements at the conclusion of the audit. Use of planning materiality, which is calculated in the planning stage of the audit to establish the extent of audit tests, is not necessarily appropriate.

- *Severe Impact.* Severe impact refers to a significant financially disruptive effect on the normal functioning of the company. It is more than just material, but less than catastrophic. For example, a matter considered important enough to influence a user's decisions is material, but the matter may not be so significant as to disrupt the normal functioning of the entity. An example of a catastrophic event is one that would result in bankruptcy, such as the inability to obtain financing.

Exhibit 1-11

Disclosing Significant Risks and Uncertainties under FASB ASC 275

	Nature of Operations	Use of Estimates	Certain Significant Estimates	Concentrations
When to Disclose?	Always.	Always.	• It is at least *reasonably possible* that the estimate of the effect on the financial statements of an existing condition will change in the *near term* due to future confirming events. AND • The change in estimate would have a *material* effect on the financial statements.	• A concentration exists at the financial statement date. AND • The concentration increases the company's vulnerability to the risk of a *near-term severe impact*. AND • It is *reasonably possible* that the events able to cause the *severe impact* could occur in the *near term*.
Threshold for Disclosing?	N/A	N/A	Potential *material* effect on financial statements.	Potential *severe impact* to the company.

	Nature of Operations	Use of Estimates	Certain Significant Estimates	Concentrations
What to Disclose?	• Description of products or services. • Relative importance of each business. • Basis used to determine relative importance of each business. • Principal markets and locations of the markets.	• Explanation that management estimates are used in preparing financial statements.	• Nature of uncertainty. • An indication that it is at least *reasonably possible* that a change in the estimate will occur in the *near term*.	• Description of the concentration. • Information about the general nature of the risk associated with the concentration. • Additional disclosures for concentrations of labor subject to collective bargaining agreements or foreign operations.

* * *

Wording the Disclosures. Applying FASB ASC 275 requires significant judgment on the part of both the auditor and the client. However, the accounting standards contain only disclosure requirements. They do not require amounts to be recorded in the financial statements. For that reason, an approach of "when in doubt, disclose" is generally recommended. In a sense, by making the disclosure, the client, as well as the auditor, transfers some of the risk due to uncertainties in the financial statements to the financial statement users themselves. By not making the disclosures, however, the client and the auditor forego an opportunity to reduce the risk that a user may successfully assert in litigation that the disclosures should have been made.

When faced with including disclosures about estimates or concentrations, clients may have concerns that the required disclosures will include information considered by management to be confidential. This is particularly true for disclosure of certain concentrations. Other concerns may include that the disclosures are too negative and could place a company at a competitive disadvantage (for example, by providing competitors with information about a company's strategy for reducing excess inventory). The guidance provides flexibility in wording the disclosures, so they can be worded in a manner that does not place the client at a competitive disadvantage. For example, when disclosing a concentration, phrases such as "a significant portion" or "a substantial percentage" are appropriate. The guidance does not require that the disclosure name names and give percentages.

Audit Procedures

The first two areas of disclosure, nature of operations and use of estimates, do not require significant audit work. However, for the other two areas of disclosure, certain significant estimates and current vulnerability due to concentrations, specific audit procedures are necessary. From an auditor's perspective, the primary objectives are determining whether all required risks and uncertainties disclosures have been identified (*completeness*) and evaluating the adequacy of presentation and disclosure.

Significant Estimates. Initially, an auditor's objective is to determine whether all significant estimates have been identified. The auditor may be aware of significant estimates from knowledge of the entity's business and operating characteristics and the industry in which it operates. Some estimates may be identified as a result of risk assessment procedures of further audit procedures applied to specific financial statement elements, such as accounts receivable and inventory.

Also, AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides guidance that is useful. The auditing standard requires that the auditor obtain an understanding, through the performance of risk assessment procedures, of how management identifies those transactions, events,

and conditions that may require accounting estimates. When doing so, the auditor is required to make inquiries of management about changes in circumstances that may result in new or changed estimates. The exhibit to AU-C 540 provides numerous examples of accounting estimates that are included in financial statements.

AU-C 540 indicates that auditors are required to obtain sufficient appropriate evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with GAAP. If there are significant risks associated with an accounting estimate, auditors are also required to evaluate the adequacy of disclosure of estimation uncertainty in the financial statements. AU-C 540.A130 notes that the importance of the auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases as the range of possible outcomes of the estimate also increases in relation to materiality.

Whenever auditors conclude there is only a remote chance of an estimate changing, best practices indicate that it is good practice to document such conclusions, particularly if the decisions are difficult or contentious. Such documentation can be unstructured and can be done, for example, on the relevant workpaper or in a separate memo. AU-C 540.22 notes that the auditor is required to document the basis for conclusions pertaining to the reasonableness of accounting estimates and their disclosure where there are significant risks.

Risk-reduction Techniques. If the criteria for disclosure listed earlier in this section are not met because the potential loss or uncertainty is mitigated by use of some risk-reduction technique, disclosure is not required. However, FASB ASC 275 states that disclosure, including a description of the risk-reduction technique, is still encouraged. If that disclosure is included, unless the auditor has obtained the necessary level of assurance that the risk-reduction technique will actually work, it is important that the description of the technique not imply that it will be effective. Wording such as "management expects" would be used instead.

If disclosure is not made because the risk is considered to be mitigated, the auditor obtains reasonable assurance that the risk-reduction technique will be effective. Essentially, the burden of proof would be on the client, and the disclosure would be made unless the client can provide the necessary assurance. The auditor should obtain sufficient appropriate audit evidence, including as necessary, independent corroboration, regarding a client's assertion that disclosure is unnecessary.

Lawyers' Letters. FASB ASC 275 supplements FASB ASC 450 relating to material pending and threatened litigation, claims, and assessments. Auditors may need to make additional inquiries of clients' attorneys to supplement the standard inquiry letters as discussed earlier in this course to obtain sufficient information. For example, the auditor may make inquiries about the likelihood of matters affecting a loss contingency *in the near term*. Or, follow-up may be necessary to assist the practitioner in determining whether it is *at least reasonably possible* that an estimate could change by a material amount. However, evaluation of whether a possible change in estimate is material is based on the auditor's judgment, and not on any materiality levels included in the attorney's letter response.

Current Vulnerability Due to Concentrations. The audit approach for concentrations is similar in many respects to the audit approach for significant estimates. That is, initially, the auditor's objective is to determine whether all concentrations have been identified. The auditor may be aware of concentrations from knowledge of the entity's business and operating characteristics and the industry in which it operates. Some concentrations may be identified as a result of audit procedures applied for specific financial statement elements.

One significant difference between auditing disclosures of concentrations and auditing disclosures of significant estimates is that the threshold for disclosure is different. For concentrations, the threshold is *severe impact*, whereas for significant estimates, the threshold is *material*.

ACCOUNTING ESTIMATES AND FAIR VALUE

Some financial statement items cannot be measured precisely but can only be estimated. Those items are referred to as *accounting estimates*. Fair value measurements are a type of accounting estimate. Accounting estimates may be recognized in the body of the financial statements (for example, the allowance for doubtful accounts or an impairment adjustment) or only disclosed in the notes(for example, disclosure of the fair value of financial instruments).

Objectives and Requirements

AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides the authoritative guidance for auditing accounting estimates, including fair values.

Objectives. The objectives of the auditor with respect to accounting estimates are to obtain sufficient appropriate audit evidence about whether (a) accounting estimates, including fair values, recognized or disclosed in the financial statements are reasonable and (b) related financial statement disclosures are adequate.

Requirements. The requirements that should be followed to achieve those objectives are summarized in Exhibit 1-12.

Exhibit 1-12

Requirements for Auditing Accounting Estimates, Including Fair Values

Requirements	AU-C Reference
Risk Assessment Procedures and Related Activities	
When obtaining an understanding of the entity and its environment, including internal control, obtain an understanding of the following to provide a basis for identifying and assessing risks of material misstatement for accounting estimates: • GAAP requirements relevant to accounting estimates, including related disclosures. • How management identifies transactions, events, and conditions that may require accounting estimates. In obtaining this understanding, inquire of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. • How management makes the accounting estimates and the data on which they are based, including— •• the method, which may include a model, used in making the estimates; •• relevant controls; •• whether management used a specialist; •• the assumptions underlying the estimates; •• whether there has been or ought to have been a change from the prior period in the methods or assumptions used in making the estimates and, if so, why; and •• whether and how management assessed the effect of estimation uncertainty.	AU-C 540.08
Review the outcome of accounting estimates included in the prior period financial statements or, if applicable, their subsequent reestimation in the current period.	AU-C 540.09
Identifying and Assessing the Risks of Material Misstatement	
In identifying and assessing risks of material misstatement, evaluate the degree of estimation uncertainty associated with an accounting estimate.	AU-C 540.10
Determine whether any accounting estimates with high estimation uncertainty give rise to significant risks.	AU-C 540.11
Responding to the Assessed Risks of Material Misstatement	
Based on the assessed risks of material misstatement, determine: • Whether management appropriately applied GAAP relevant to the accounting estimate. • Whether the methods for making accounting estimates are appropriate and consistently applied and whether any changes from the prior period in accounting estimates or the methods for making them are appropriate in the circumstances.	AU-C 540.12

Requirements	AU-C Reference
Perform one or more of the following, depending on the nature of the accounting estimate: • Determine whether events occurring up to the date of the auditor's report provide audit evidence about the accounting estimate. • Test how management made the accounting estimate and the data on which it is based. In doing so, evaluate whether— •• the measurement method is appropriate in the circumstances, •• the assumptions used by management are reasonable in light of the measurement objectives of GAAP, and •• the data on which the estimate is based are sufficiently reliable. • Test the operating effectiveness of the controls over how management made the accounting estimate and perform appropriate substantive procedures. • Develop a point estimate or range to evaluate management's estimate. For this purpose— •• If the assumptions or methods used to make the estimate differ from management's, obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's estimate. •• If it is appropriate to use a range, narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.	AU-C 540.13
In determining whether GAAP and management's estimation methods have been properly applied and in responding to the assessed risks of material misstatement, consider whether specialized skills or knowledge are required to obtain sufficient appropriate audit evidence.	AU-C 540.14
Further Substantive Procedures to Respond to Significant Risks	
For accounting estimates that give rise to significant risks, evaluate the following: • How management considered alternative assumptions or outcomes and why it rejected them or how management otherwise addressed estimation uncertainty in making the accounting estimate. • Whether the significant assumptions used by management are reasonable. • When relevant to the reasonableness of the significant assumptions used by management or the appropriate application of GAAP, management's intent and ability to carry out specific courses of action.	AU-C 540.15
If management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, develop a range to use in evaluating the reasonableness of the accounting estimate if considered necessary.	AU-C 540.16
For accounting estimates that give rise to significant risks, obtain sufficient appropriate audit evidence about whether the following are in accordance with GAAP: • Management's decision to recognize or not recognize the accounting estimates in the financial statements. • The selected measurement basis for the accounting estimates.	AU-C 540.17
Evaluating the Reasonableness of Estimates and Determining Misstatements	
Evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are reasonable in the context of GAAP or are misstated.	AU-C 540.18
Disclosures	
Obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with GAAP.	AU-C 540.19
For accounting estimates that give rise to significant risks, evaluate the adequacy of the disclosure of estimation uncertainty in the financial statements in accordance with GAAP.	AU-C 540.20
Indicators of Bias	
Review management's judgments and decisions made in making accounting estimates to identify whether there are indicators of possible management bias.	AU-C 540.21

Requirements	AU-C Reference
Documentation	
Document the following: • For accounting estimates that give rise to significant risks, the basis for conclusions about the reasonableness of the accounting estimates and their disclosure. • Any indicators of possible management bias.	AU-C 540.22

* * *

Accounting Estimates

Preparation of financial statements normally requires making accounting estimates. AU-C 540.07 defines an *accounting estimate* as "an approximation of a monetary amount in the absence of a precise means of measurement." The nature and reliability of information available to management when making estimates will vary. As a result, the degree of estimation uncertainty associated with estimates will vary. The degree of estimation uncertainty affects the risk of material misstatement of estimates. AU-C 540.07 defines *estimation uncertainty* as "the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement." Among other estimates, accounting estimates include fair value accounting estimates and related disclosures.

AU-C 540.A6 provides the following examples of circumstances when accounting estimates, other than fair value accounting estimates, may be required:

a. Allowance for doubtful accounts.

b. Reserves for inventory obsolescence.

c. Depreciation methods or asset lives.

d. Impairment of an investment.

e. Warranty obligations.

f. Outcome of long-term contracts.

g. Litigation settlements and judgments.

Examples of circumstances when fair value accounting estimates may be required include:

a. Complex financial instruments not traded in an active and open market.

b. Share-based payments.

c. Property or equipment held for disposal.

d. Certain assets or liabilities acquired in a business combination.

e. Certain nonmonetary exchanges.

The exhibit to AU-C 540 provides additional examples of accounting estimates.

Auditing Accounting Estimates

When auditing accounting estimates, AU-C 540 emphasizes that the auditor should follow a risk-based approach. Also, the auditor should understand the requirements of GAAP relating to relevant estimates, including

the pertinent disclosure requirements. The understanding of GAAP requirements will provide a basis for the auditor's evaluation of management's recognition and measurement of accounting estimates along with related disclosures that may be necessary.

Risk Assessment Procedures and Related Activities. AU-C 540.08 indicates that the auditor should obtain an understanding of how management identifies and makes accounting estimates through the performance of risk assessment procedures as part of obtaining an understanding of the entity and its environment. This understanding helps the auditor in developing an expectation of the nature and type of accounting estimates the client may have. Ultimately, the purpose of the auditor's understanding is to identify and assess the risks of material misstatement associated with accounting estimates. Specifically, the auditor's understanding should include the following:

- How management identifies transactions, events, and conditions that require accounting estimates.
- How management makes estimates along with the underlying data used, including the methods, assumptions, relevant controls, specialists required, changes from prior periods in method or assumptions, and whether and how estimation uncertainty has been assessed.

The auditor is also required to perform a review of the outcome of accounting estimates that were included in the prior period. Generally, the outcome of an accounting estimate will differ from the amount that was recognized in the prior period. By identifying and understanding the reasons for such differences, the auditor may obtain information about the effectiveness of management's prior period estimation process, audit evidence that is pertinent to re-estimation of prior period estimates in the current period, or evidence of matters requiring disclosure in the financial statements such as estimation uncertainty. In addition, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires a retrospective review of management's judgments or assumptions related to significant accounting estimates included in prior period financial statements to determine if there is an indication of management bias and a risk of material misstatement due to fraud. As a practical matter, both reviews can be coordinated when reviewing prior period estimates.

Through the performance of risk assessment procedures and related activities directed towards accounting estimates, the auditor should identify and assess risks associated with the development of accounting estimates. In doing so, the auditor is also required to evaluate the degree of estimation uncertainty associated with accounting estimates. The auditor is also required to determine if those estimates with high estimation uncertainty represent significant risks. For identified significant risks, the auditor is required to understand the entity's controls, including control activities. Accounting estimates with a higher degree of estimation uncertainty also might be susceptible to management bias.

The following factors may influence the degree of estimation uncertainty associated with an accounting estimate:

- Extent to which the estimate relies on judgment.
- Sensitivity of the estimate to changes in assumptions.
- Existence of measurement techniques that may mitigate the estimation uncertainty.
- Length of the forecast period and the relevance of data taken from past events to forecast future events.
- Availability of reliable data from external sources.
- Extent to which observable or unobservable inputs are used.

AU-C 540.A47 provides examples of accounting estimates that can have high estimation uncertainty. Such estimates might have the following characteristics:

- Highly dependent upon judgment.
- Not calculated using recognized measurement techniques.

- Similar estimates in the prior period had substantial differences from the actual outcome.
- For fair value accounting estimates, a highly specialized, entity-developed model is used or for which there are no observable inputs.

Responding to the Assessed Risks of Material Misstatement. The auditor's further audit procedures for identified accounting estimates should be responsive to the assessment of risks of material misstatement that relate to those estimates. As with all items recognized and measured in the financial statements, including those matters required for disclosure, the auditor has a general requirement relating to estimates to determine whether GAAP, such as the requirements of FASB ASC 825, has been properly applied by management. In addition, the auditor is responsible for determining whether the methods used by management are appropriate and have been applied consistently. If there has been a change from the prior period in estimates or the methods, the auditor should determine if such changes are appropriate in the circumstances.

In responding to assessed risks for accounting estimates, AU-C 540 requires the auditor to do one or more of the following:

- Test the operating effectiveness of the controls over how management made the estimate, along with appropriate substantive procedures.
- Determine if subsequent events up to the date of the auditor's report provide audit evidence about the estimate.
- Test how management made the estimate and the underlying data, including the evaluation of the appropriateness of the method, reasonableness of the assumptions, and the reliability of the underlying data.
- Develop a point estimate or range to evaluate management's point estimate.

The approach selected by the auditor will normally depend on the nature of the estimate, the effectiveness of the procedure in providing sufficient appropriate audit evidence, and the assessed risk of material misstatement, including if the risk is considered to be a significant risk.

Testing how management made the estimate and underlying data is often an appropriate response when the accounting estimate is a fair value accounting estimate.

AU-C 540.A93 notes that the auditor's development of a point estimate or range to evaluate management's point estimate might be an appropriate response when, for example:

- The estimate is not derived from the routine processing of data by the accounting system.
- Prior audit results for similar estimates indicate management's current estimation process is unlikely to be effective.
- Controls relating to the development of the estimate are not well-designed or properly implemented.
- Subsequent events contradict management's point estimate.
- Alternative sources of relevant data are available to the auditor that can be used in developing a point estimate or range.

When developing a point estimate or a range, the auditor is required to understand management's assumptions and methods if they vary from those the auditor uses. The understanding should be sufficient to ensure that the auditor's point estimate or range considers relevant variables, as well as to evaluate any differences in the auditor's results from those of management. Also, when the auditor finds it appropriate to use a range, the auditor should narrow the range until all outcomes are considered reasonable. In other words, the auditor seeks to limit the range to reasonable outcomes versus all possible outcomes. In doing so, the auditor eliminates outcomes that are

unlikely to occur and continues narrowing the range until all outcomes are considered to be reasonable. Typically, a range that has been narrowed to be equal or less than performance materiality, is adequate for evaluating the reasonableness of management's point estimate.

Significant Risks. When the auditor has determined that there is a significant risk associated with an accounting estimate, AU-C 540 outlines certain procedures that should be performed in addition to other substantive procedures performed to respond to the risks of material misstatement. The focus is on how management has assessed the effect of estimation uncertainty on the accounting estimate and how that uncertainty affects the appropriateness of the amount in the financial statements, as well as the adequacy of disclosures. The auditor is required to evaluate:

- How management considered alternative assumptions and why they were rejected or how estimation uncertainty was addressed in making the accounting estimate (e.g., the use of a sensitivity analysis).
- Whether the significant assumptions used by management are reasonable.
- When relevant to the reasonableness of the significant assumptions used by management or the application of GAAP, management's intent and ability to carry out a specific course of action.

If the auditor deems that management has not adequately addressed the effects of estimation uncertainty, the auditor should, when necessary, develop a range to evaluate the reasonableness of the estimate.

Furthermore, for accounting estimates with significant risks, the auditor is required to obtain sufficient appropriate evidence about whether management's decision to recognize, or not recognize, the estimate, as well as the measurement basis, are in accordance with GAAP. For example, in certain cases, GAAP may prescribe that amounts should not be recognized if they cannot be reasonably estimated or it is not practicable to estimate amounts. Even if amounts are not recognized under GAAP, there may be a need for disclosure of the circumstances in the notes to the financial statements. In some cases, there may be a need for the auditor to add an additional paragraph to the auditor's report to emphasize the matter.

Evaluating the Reasonableness of Estimates and Determining Misstatements. When evaluating the reasonableness of management's estimates, if the audit evidence supports a point estimate, a misstatement represents the difference between the auditor's point estimate and the amount recorded by management. If the auditor has developed a range and management's estimate falls outside that range, the misstatement is at least the difference between management's point estimate and the nearest point of the auditor's range. For example, if the auditor's range is $1,200 to $1,500 for the allowance for uncollectible accounts, but the client has chosen to estimate $1,000 for the allowance, then there is at least a $200 misstatement that should be included with other audit differences.

Disclosures. AU-C 540 emphasizes that the auditor should obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements relating to accounting estimates are in accordance with GAAP. The auditor would still need to determine whether enough audit evidence has been collected to support the matters presented in the disclosures.

When an accounting estimate has significant risks, the auditor is required to evaluate the disclosures pertaining to estimation uncertainty in the financial statements. In some cases, even though the client's disclosures might comply with the requirements of GAAP, the auditor may deem that they are inadequate in light of the circumstances and facts that are involved. The auditor's emphasis on the evaluation of the adequacy of disclosures would increase as the range of possible outcomes for management's accounting estimate increases in relationship to materiality.

Indicators of Possible Management Bias. AU-C 540.21 requires the auditor to review judgments and decisions made by management when making accounting estimates to determine if there are any indicators of possible management bias. Indications of management bias may affect the auditor's conclusions regarding risk assessment and whether there are implications for the rest of the audit. AU-C 540.A134 provides the following examples of indicators of possible management bias regarding accounting estimates:

- Changes in an estimate, or the underlying method, when management has made a subjective assessment that there has been a change in circumstances.

- The entity uses its own assumptions for fair value accounting estimates that are inconsistent with observable market assumptions.

- Selection or construction of significant assumptions that result in a favorable point estimate for management's purposes.

- Selection of a point estimate that indicates a pattern of optimism or pessimism.

AU-C 240.32 also requires the auditor to review estimates for bias and evaluate whether underlying circumstances represents a risk of material misstatement due to fraud. Similar to AU-C 540, AU-C 240 requires the auditor to evaluate whether the judgments and decisions made by management when making the estimate indicate possible bias, even if they are individually reasonable. If so, the auditor is required to reevaluate accounting estimates as a whole. The auditor might also consider whether differences between estimates best supported by the audit evidence, and the estimates included in the financial statements that are individually reasonable, indicate (in the aggregate) a possible bias on the part of management. If management, for example, always chooses estimated amounts for the valuation of assets that are at the low end of the range the auditor considers reasonable, the combined effect could result in a material misstatement of income. In that case, the auditor would consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates. The auditor might also consider whether management's estimates were at one end of the auditor's reasonable range in the prior year and at the other end in the current year. That could indicate the possibility that management is using accounting estimates to manage earnings.

AU-C 240.32 further requires auditors to perform a retrospective review of significant prior-year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. The items selected for review should be those estimates based on highly sensitive assumptions or are significantly affected by judgments made by management. The review may provide additional information about whether the current year's estimates could be biased.

Documentation. AU-C 540.22 requires the following matters related to accounting estimates to be included in audit documentation:

- For accounting estimates with significant risks, the basis of conclusions about the reasonableness of the estimate and related disclosures.

- Indicators of management bias.

Fair Value Measurements and Disclosures

The requirements of AU-C 540 discussed earlier in this section apply to the auditor when auditing fair value accounting estimates. The following paragraphs discuss some the relevant accounting guidance and auditing considerations that are unique to fair value measurements and disclosures.

Accounting Standards. GAAP provides a number of requirements for fair value measurements and disclosures. The following is an overview of the fair value accounting requirements.

FASB ASC 825, *Financial Instruments*, primarily requires certain entities to disclose (a) the fair values of financial instruments for which it is practical to estimate fair values and (b) concentrations of credit risk. Disclosure about market risk of financial instruments are encouraged, but not required. However, as described in the following paragraph, most small nonpublic companies are exempt from FASB ASC 825's required disclosures about concentrations of credit risk and the fair value of financial instruments.

FASB ASC 825-10-50-3 made disclosures about the concentrations of credit risk and fair value of financial instruments optional for companies that meet the following criteria:

- The company is a nonpublic company.

- The company's total assets are less than $100 million on the date of the financial statements.

- The company has no instrument (other than a commitment related to the origination of a mortgage loan to be held for sale) that, in whole or in part, is accounted for as a derivative during the reporting period. For purposes of this disclosure guidance, a receive-variable, pay-fixed interest rate swap for which the simplified hedge accounting approach (described in FASB ASC 815-20) is applied shall not be considered an instrument that is accounted for as a derivative instrument under FASB ASC 815.

FASB ASC 820 applies whenever other standards require (or permit) fair value measurements or disclosures about fair value measurements. FASB ASC 820 defines *fair value*, provides a framework for measuring fair value within GAAP, and provides disclosures about fair value measurements. Fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal market for the asset or liability (or most advantageous market, if there is no principal market). The guidance requires that fair value be based on the assumptions market participants would use when pricing the asset or liability, and it establishes a fair value hierarchy of information used to develop those assumptions. Under the hierarchy, quoted prices in active markets have the highest priority and unobservable data, for example, the reporting entity's own data, has the lowest priority. The guidance requires fair value measurements to be separately disclosed by level within the fair value hierarchy.

FASB ASC 825 provides an option to report selected financial assets and financial liabilities at fair value. The requirements also apply to other items such as written loan commitments and certain items that are not financial instruments. The election can be made on an instrument-by-instrument basis and is irrevocable, once made. There are also presentation and disclosure requirements that facilitate comparisons between entities that choose different measurement attributes. However, it does not eliminate disclosure requirements about fair value measurements included in other standards.

Auditing Fair Value Measurements and Disclosures. The requirements of AU-C 540 discussed earlier in this section apply to auditing fair value accounting estimates. Therefore, when the auditor is auditing estimated fair value measurements recognized or disclosed in the financial statements, the guidance of AU-C 540 relating to risk assessment procedures, identifying and assessing risks, responding to assessed risks including significant risks, as well as other required matters, should govern the auditor's procedures.

When responding to the assessed risks of material misstatement for accounting estimates, the auditor will use one or more approaches, one of which is testing how management made the estimate and the underlying data, including the evaluation of the appropriateness of the method, reasonableness of the assumptions, and the reliability of the underlying data. That approach is frequently used when the accounting estimate involves fair value determined using a valuation method.

Some fair values are readily determinable because there are relevant quoted market prices. For such items, published price quotations in an active market are the best evidence of fair value. When there is no observable market price or items have characteristics requiring an estimate to be made, use of a valuation method, such as discounted cash flows, may provide the best estimate of fair value.

When a valuation method is used, the auditor considers the appropriateness of the method, including management's rationale for selecting the method. Auditors may consider whether management has evaluated the range of values resulting from different methods and investigated the reasons for the differences. Changes in circumstances may require changes in the method used to determine fair value. If there has been a change from the prior period in estimates or the methods, the auditor should determine if such changes are appropriate in the circumstances.

The following approaches may be used to obtain evidence supporting a fair value estimate determined using a valuation model:

- Test the client's valuation process, including management's assumptions (or those of a specialist), the valuation model, and the underlying data.
- Develop an independent estimate and compare it to the client's valuation.
- Review subsequent events and transactions to corroborate the client's valuation. (However, the auditor should consider only those events or transactions that reflect circumstances existing at the balance sheet date.)

When testing the client's valuation process or developing an independent estimate based on management's assumptions, the auditor should evaluate whether management's assumptions are reasonable and consistent with market information. If management retained a specialist to develop the valuation, the auditor's responsibility to test the assumptions does not change. The auditor considers the source and reliability of evidence supporting the assumptions, pays special attention to assumptions that are highly sensitive or uncertain and those susceptible to misapplication or bias, and considers the sensitivity of the valuation to changes in assumptions and market conditions. To be reasonable, the assumptions, individually and taken as a whole, need to be realistic and consistent with the following:

- The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances.
- Existing market information.
- The plans of the entity, including what management expects will be the outcome of specific objectives and strategies.
- Assumptions made in prior periods, if appropriate.
- Past experience of, or previous conditions experienced by, the entity to the extent it is considered representative of future conditions.
- Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures.

AU-C 540.A83 also provides additional matters the auditor might consider when evaluating the reasonableness of assumptions pertaining to fair value accounting estimates, including:

- When relevant, whether and how market-specific inputs have been included in the development of assumptions.
- Whether assumptions are consistent with observable market conditions and the characteristics of the asset or liability measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable.
- When a number of different market participant assumptions exist, how management selected the assumptions to use.
- Whether and how management considered assumptions used in comparable transactions, assets, or liabilities.

When there are unobservable inputs, the auditor's evaluation of the assumptions will likely be combined with other responses to assessed risks as discussed earlier. Also, fair value accounting estimates with unobservable inputs as a result of illiquid markets may provide challenges to management. Therefore, the auditor would consider the risks that may exist for such estimates when assessing the risks of material misstatement and developing appropriate responses.

The accuracy, completeness, and relevancy of the underlying data should also be tested, and the auditor should ensure that the resulting valuation properly reflects both the assumptions and the data. Tests may include verifying the source of the data, recomputation, and review of information for internal consistency.

The auditor who independently develops assumptions for use in evaluating the client's estimate still needs to understand management's assumptions so he or she can assess whether any significant matters have been omitted and can evaluate any significant differences between management's and the auditor's estimates as discussed earlier.

For certain valuations, best practices indicate that the development of an independent estimate or the use of subsequent events to corroborate the client's valuation will not be practical or may be of limited usefulness. For example, when auditing fair values for stock options, if the client uses a valuation model such as Black-Sholes-Merton or another established model, it would be of limited usefulness for the auditor to develop an independent estimate. Also, for stock options or long-term liabilities such as asset retirement obligations, the use of subsequent events would generally not apply.

When auditing fair value disclosures, the following guidance applies:

- Evaluation of whether fair value disclosures are in conformity with GAAP ordinarily involves the same audit procedures used to audit fair value measurements recognized in the financial statements.

- If fair value disclosure is omitted because it is not practical to determine fair value with sufficient reliability, information that would be pertinent to such an estimate should be disclosed along with the reasons why it is not practical to estimate fair value. In that case, the adequacy of disclosures required in such circumstances is evaluated.

During summarization and evaluation procedures, the auditor should evaluate the sufficiency of the evidence obtained and its consistency with other evidence obtained during the audit. Regardless of the audit approach used, the auditor would ordinarily obtain management representations about the reasonableness of significant assumptions and consider certain communications with those charged with governance.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Ethel is evaluating Clark's Fabric Shop's ability to continue as a going concern. As part of her risk assessment procedures, she is required to do which of the following, according to AU-C 570?

    a. Determine if management has performed a preliminary evaluation of whether conditions or events have been identified that raise doubt about the entity's ability to continue as a going concern.

    b. Assess possible effects on the financial statements, for example, the adequacy of disclosure regarding an entity's ability to continue as a going concern for a reasonable period of time.

12. Which of the following is **not** an example of a procedure that might provide evidence about a condition or event that could affect the entity's ability to continue as a going concern?

    a. Evaluation of cash flow forecasts.

    b. Inquiry of an entity's legal counsel regarding a lawsuit.

    c. Determining if there has been a loss of a major supplier.

    d. Discuss with an entity's legal counsel their knowledge of the identity of principal parties to material transactions.

13. Auditors need to consider management's plans to lessen the adverse effects of identified conditions and events when there is a substantial doubt as to the entity's ability to continue as a going concern for a reasonable period of time. What should the auditor be evaluating regarding plans to delay expenses?

    a. The feasibility of postponing a research project.

    b. Likelihood of plans to increase ownership equity.

    c. How marketable the assets are that management intends to sell.

    d. Debt financing availability.

14. James is auditing the financial statements of Hill Country Cattle Company. He includes a disclosure that relates to the credit risk that Hill Country has due to most sales being credit sales. James is communicating a disclosure requirement required by FASB ASC 275 related to which area?

    a. Current vulnerability due to concentrations.

    b. Nature of operations.

    c. Use of estimates.

    d. Certain significant estimates.

15. Rancho Diego Builders, a construction company, is including a disclosure about a future event that *could* happen. The chance of this event occurring is more than slight, but less than likely. How would this event be classified?

    a. Remote.

    b. Reasonably possible.

    c. Probable.

16. William is performing an audit of Verde Foods. When disclosing significant risks and uncertainties under FASB ASC 275 for the use of estimates, which of the following should William disclose?

    a. A description of the concentrations that could potentially severely impact the entity.

    b. An explanation of each type of product or service that the entity provides.

    c. An indication that the estimate is at least reasonably possible and will happen in the near term.

    d. Clarification that the estimates were prepared by management and used in preparing the financial statements.

17. Luke is auditing Herron Industries, a nonpublic company. Herron Industries' financial statements contain numerous accounting estimates. Herron Industries may be required to use a fair value accounting estimate for which of the following?

    a. Reserves for outdated inventory.

    b. Doubtful account allowances.

    c. Methods of depreciation.

    d. Complex financial instruments not traded in an open or active market.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Ethel is evaluating Clark's Fabric Shop's ability to continue as a going concern. As part of her risk assessment procedures, she is required to do which of the following, according to AU-C 570? **(Page 338)**

    a. Determine if management has performed a preliminary evaluation of whether conditions or events have been identified that raise doubt about the entity's ability to continue as a going concern. [This answer is correct. As part of risk assessment procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events have been identified. If so, auditors and management discuss management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, as well as plans to address any issues identified. If management has not yet made such an evaluation, the auditor has to discuss with management why management intends to use the going-concern basis and inquire as to any existing conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.]

    b. Assess possible effects on the financial statements, for example, the adequacy of disclosure regarding an entity's ability to continue as a going concern for a reasonable period of time. [This answer is incorrect. One of the auditor's objectives under AU-C 570 is to evaluate possible effects on financial statements, such as the adequacy of disclosure regarding an entity's ability to continue as going concern for a reasonable period of time. This is not required as a part of the risk assessment procedures. Another objective would be to issue an auditor's report in accordance with the auditing standard.]

12. Which of the following is **not** an example of a procedure that might provide evidence about a condition or event that could affect the entity's ability to continue as a going concern? **(Page 342)**

    a. Evaluation of cash flow forecasts. [This answer is incorrect. Reviewing forecasts of cash flow or profit is a procedure that may identify conditions or events that might affect the entity's ability to continue as a going concern.]

    b. Inquiry of an entity's legal counsel regarding a lawsuit. [This answer is correct. Inquiring of an entity's legal counsel about litigation, claims, and assessments is on example provided by AU-C 570.A1 that might provide evidence about an entity's ability to continue as a going concern. Other examples include applying analytical procedures, and reviewing subsequent events.]

    c. Determining if there has been a loss of a major supplier. [This answer is incorrect. Considering whether there has been loss of a major customer, license, supplier, franchise, or market is a procedure that may identify conditions or events that might affect the entity's ability to continue as a going concern.]

    d. Discuss with an entity's legal counsel their knowledge of the identity of principal parties to material transactions. [This answer is incorrect. This procedure is performed to identify undisclosed related parties.]

13. Auditors need to consider management's plans to lessen the adverse effects of identified conditions and events when there is a substantial doubt as to the entity's ability to continue as a going concern for a reasonable period of time. What should the auditor be evaluating regarding plans to delay expenses? **(Page 344)**

    a. The feasibility of postponing a research project. [This answer is correct. When delaying or reducing expenditures, auditors should consider the feasibility of plans to reduce overhead or administrative costs, to postpone maintenance or research and development projects, or to lease rather than purchase assets, and the possible direct or indirect effects of reduced or delayed expenditures.]

    b. Likelihood of plans to increase ownership equity. [This answer is incorrect. When increasing ownership equity, auditors should consider the apparent feasibility of plans to increase ownership equity, including existing agreements or commitments to raise capital; and existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors.]

    c. How marketable the assets are that management intends to sell. [This answer is incorrect. When planning to dispose of assets, auditors should consider the restriction on disposal of assets, such as encumbrances on assets and covenants in loan or similar agreements that limit asset dispositions; the apparent marketability of assets that management plans to sell; and the possible direct or indirect effects of disposal assets.]

    d. Debt financing availability. [This answer is incorrect. When planning to restructure debt or borrow money, auditors should consider the availability of debt financing, including existing agreements and commitments such as lines of credit, arrangements for factoring receivables, or sale-leaseback agreements; the possible effects on management's borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral; and the existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity.]

14. James is auditing the financial statements of Hill Country Cattle Company. He includes a disclosure that relates to the credit risk that Hill Country has due to most sales being credit sales. James is communicating a disclosure requirement required by FASB ASC 275 related to which area? **(Page 348)**

    a. Current vulnerability due to concentrations. [This answer is incorrect. FASB ASC 275 requires disclosure of concentrations that meet certain criteria. A large concentration of credit sales is not one of those criteria. The types of concentrations that should be considered for disclosure are as follows: (1) concentrations in volume of business transacted with a particular customer, supplier or lender, (2) concentrations in revenue from particular products or services, (3) concentrations in the available sources of supply of materials, labor or services and (4) concentrations in the market or geographic area in which an entity conducts its operations.]

    b. Nature of operations. [This answer is correct. All financial statements should include a description of the major products or services the reporting entity sells or provides and the entity's principal markets per FASB ASC 275 requirements. If all or most of a company's sales are credit sales, disclosures about concentrations of credit risk required by FASB ASC 825 may accomplish the disclosure of the company's principal markets.]

    c. Use of estimates. [This answer is incorrect. FASB ASC 275 requires financial statement disclosures to include an explanation that preparation of financial statements requires the use of management's estimates and acknowledges that the disclosure will usually be standardized. This would not encompass the company's regular method of sales, such as credit sales.]

    d. Certain significant estimates. [This answer is incorrect. FASB ASC 275 requires additional disclosures for certain significant estimates. Disclosing that the majority of the company's sales are credit sales would not qualify as an estimate. Significant estimates are required to be disclosed when both of the following criteria are met: (1) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events and (2) the effect of the change would be material to the financial statements.]

15. Rancho Diego Builders, a construction company, is including a disclosure about a future event that *could* happen. The chance of this event occurring is more than slight, but less than likely. How would this event be classified? **(Page 349)**

    a. Remote. [This answer is incorrect. Remote is defined by FASB ASC 275 as the chance of the future event occurring is slight.]

    b. Reasonably possible. [This answer is correct. FASB ASC 275 defines reasonably possible as the chance of the future event occurring is more than remote but less than likely.]

    c. Probable. [This answer is incorrect. Probable is defined by FASB ASC 275 as the future event or events are likely to occur.]

16. William is performing an audit of Verde Foods. When disclosing significant risks and uncertainties under FASB ASC 275 for the use of estimates, which of the following should William disclose? **(Page 350)**

    a. A description of the concentrations that could potentially severely impact the entity. [This answer is incorrect. A description of the concentration is a requirement of FASB ASC 275 when the concentration has the potential to severely impact the entity *if* certain other criteria are met.]

    b. An explanation of each type of product or service that the entity provides. [This answer is incorrect. A description of the products or services that an entity provides would be part of the disclosure about nature of operations required by FASB ASC 275. This disclosure is always required in relation to risks and uncertainties.]

    c. An indication that the estimate is at least reasonably possible and will happen in the near term. [This answer is incorrect. Per FASB ASC 275, the disclosure that the estimate is at least reasonably possible and will occur in the near term is required for certain significant estimates only if certain criteria are met.]

    d. Clarification that the estimates were prepared by management and used in preparing the financial statements. [This answer is correct. According to FASB ASC 275, the disclosure that is required when using estimates is an explanation that management estimates were used in preparing the financial statements and this disclosure should always be included.]

17. Luke is auditing Herron Industries, a nonpublic company. Herron Industries' financial statements contain numerous accounting estimates. Herron Industries may be required to use a fair value accounting estimate for which of the following? **(Page 355)**

    a. Reserves for outdated inventory. [This answer is incorrect. AU-C 540.A6 requires that reserve for inventory obsolescence must utilize an accounting estimate, but not a fair value accounting estimate.]

    b. Doubtful account allowances. [This answer is incorrect. Herron Industries must calculate the allowance for doubtful accounts with an accounting estimate, but a fair value accounting estimate is not required AU-C 540.A6.]

    c. Methods of depreciation. [This answer is incorrect. AU-C 540.A6 requires that depreciation methods or asset lives must utilize an accounting estimate, but do not require fair value accounting estimates.]

    d. Complex financial instruments not traded in an open or active market. [This answer is correct. An example of a circumstance when a fair value accounting estimate may be required by AU-C 540.A6 is when complex financial instruments are not traded in an active or open market.]

CONSIDERING THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

This section discusses certain requirements related to considering the accumulated results of audit procedures under AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, and AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Exhibit 1-13 summarizes those requirements.

Exhibit 1-13

Requirements Related to Considering the Accumulated Results of Audit Procedures[a]

Requirements	AU-C Reference
Perform audit procedures to evaluate whether the overall presentation of the financial statements, including related disclosures, is in accordance with GAAP.	AU-C 330.26
Based on the audit procedures performed and evidence obtained, evaluate before the conclusion of the audit whether the risk assessments at the relevant assertion level are still appropriate.	AU-C 330.27
Conclude whether sufficient appropriate evidence has been obtained, considering all relevant audit evidence regardless of whether it corroborates or conflicts with assertions in the financial statements.	AU-C 330.28
If sufficient appropriate audit evidence about an assertion has not been obtained, attempt to obtain further audit evidence. If unable to do so, express a qualified opinion or disclaim an opinion on the financial statements.	AU-C 330.29
Evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud. The analytical procedures relating to revenue should be performed through the end of the reporting period.	AU-C 240.34
Evaluate the business rationale (or the lack thereof) for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual given the understanding of the entity and its environment and other information obtained during the audit, to address whether the business rationale of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.	AU-C 240.32, item c[b]
Revise the risk assessment and modify the further planned audit procedures if new information is obtained or if the initial assessed risks of material misstatement at the assertion level changes during the audit.	AU-C 315.32

Notes:

[a] The requirements for evaluating misstatements, including those in AU-C 240 related to evaluating whether misstatements are indicative of fraud and the related implications for the audit, are discussed later in this course.

[b] This procedure is required to address the risk of management override of controls.

* * *

Reevaluating Risk Assessments and Evaluating Audit Evidence

The auditor's assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional evidence is obtained. For example, in performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than

had been anticipated. AU-C 315.32 requires the auditor to revise the risk assessment and modify further planned audit procedures if new information is obtained or if the initial assessed risks of material misstatement at the assertion level changes during the audit. Furthermore, AU-C 330.27 requires the auditor to reevaluate, before the conclusion of the audit, whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evidence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures. Exhibit 1-14 (as adapted from paragraph 7.04 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*) illustrates this concept.

Exhibit 1-14

Reevaluating the Initial Assessment of the Risk of Material Misstatement at the Relevant Assertion Level

When planning the audit of ABC Company, the auditor initially assessed a low level of risk that the company would not record year-end sales in the proper period. The auditor then determined the nature, timing, and extent of substantive procedures related to the cut-off assertion based on her assessment of a relatively low risk of material misstatement. However, the company's warehouse and accounting personnel were confused about how to record orders that were prepared for shipping on December 31, but not picked up by the shipping service until January 2.

In her examination of accounts receivable, the auditor sent confirmations to a sample of customers. Confirmation results indicated a likely misstatement. The auditor informed management and the resulting investigation led to identifying cut-off issues as the cause of the misstatement. As a result, the auditor (1) asked management to examine the accounts receivable and revenue account balances to identify and correct any other misstatements, and (2) reevaluated her initial risk assessment relating to cut-off and increased the extent of tests of details over shipping cut-off in order to obtain a higher level of assurance that all material misstatements relating to cut-off errors had been identified.

* * *

As indicated in Exhibit 1-14, an auditor can not assume that an identified error or especially, an instance of fraud is an isolated occurrence. Instead, the auditor needs to consider how the misstatement affects the assessed risks of material misstatement. (Additionally, misstatements may indicate a significant deficiency or material weakness in internal control.) In doing so, the auditor should consider all relevant audit evidence, even if it appears to contradict relevant assertions in the financial statements.

It is natural for a business entity to have some deviations in the way controls are applied. Deviations may be caused by such factors as changes in key personnel, seasonal fluctuations in business activity, and human error. As a result, controls may not operate as effectively as the auditor had expected. If the auditor detects deviations when performing tests of controls, he or she makes inquiries to understand such matters and their potential consequences and should determine whether the tests provide an appropriate basis for reliance on the controls, whether additional tests of controls are needed, or whether the potential risks of misstatement need to be addressed by substantive procedures. The auditor should also evaluate whether misstatements identified when performing substantive procedures indicate that the related controls are not operating effectively. However, the absence of identified misstatements when performing substantive procedures does not provide audit evidence that the controls related to the relevant assertion being tested are effective.

At the end of the audit, the auditor should conclude whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement.

The sufficiency and appropriateness of audit evidence is a matter of the auditor's professional judgment. AU-C 330.A75 explains that the auditor's judgment is influenced by factors such as:

- Significance of the potential misstatement in the relevant assertion and the likelihood of it materially affecting the financial statements—individually and when aggregated with other misstatements.
- Effectiveness of responses by management and controls to address the risks.
- Experience gained during prior audits regarding similar potential misstatements.
- Results of audit procedures, including whether specific instances of fraud or error were identified.
- Reliability and source of available information.
- Persuasiveness of available audit evidence.
- Understanding of the entity and its environment, including internal control.

AU-C 330.29 states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

Evaluating the Existence of Fraud

Fraud Risk Assessment Is an Ongoing Process. Assessing the risks of material misstatement due to fraud is an ongoing process that should occur throughout the audit. Fraud risks may be identified during the engagement acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, when assessing the risks of material misstatement of the financial statements due to error or fraud, when performing further audit procedures to respond to assessed risks, or when communicating with management or others. Examples of conditions the auditor may note that may change or support the assessment of fraud risks made during planning are included in Exhibit 1-15.

Exhibit 1-15

Conditions That May Change or Support the Auditor's Assessment of Fraud Risks

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, or company policy.
- Balances or transactions that are unsupported or unauthorized.
- Adjustments made by the entity at the last minute that substantially affect financial results.
- Evidence of employees' unauthorized or unnecessary access to systems or records.
- Missing documents.
- Indications of altered documents.[a]
- Only photocopies or electronic versions of documents being provided to auditors when originals are expected to exist.
- Significant unexplained reconciling items.
- Vague, implausible, or inconsistent responses by the client to the auditor's inquiries.

- Significant amounts of inventory or other physical assets are missing.
- Denial by client personnel of auditor's access to records, facilities, certain employees, customers, vendors, or others.[b]
- Unusual discrepancies between confirmation replies and the entity's records.
- Failure to retain documents or electronic files consistent with the company's record retention policies or practices.
- Unusual delays by client personnel in providing requested information.
- Unreasonable time pressures to resolve complex or contentious accounting issues.
- Attempts by management to intimidate audit team members or control the conduct of the audit.
- Complaints or tips received by the auditor about fraud or potential fraud.
- Unwillingness to make financial statement disclosures more clear or complete.
- Management's proposal of adjustments, not previously identified or communicated to the auditor, that offset misstatements found by the auditor.
- Evidence of management bias in accounting estimates.

Notes:

[a] If the auditor suspects that documents have been altered, it may be necessary to engage a document expert to determine their authenticity.

[b] Denial of access to information may constitute a limitation on the scope of the audit sufficient to preclude an unmodified opinion on the financial statements.

* * *

Required Procedures. AU-C 240.34 requires auditors to evaluate, at or near the completion of fieldwork, whether the accumulated results of auditing procedures (including analytical procedures performed as substantive tests or in the overall review stage of the audit), affect the assessment made earlier in the audit regarding the risks of material misstatement due to fraud or indicate a previously unidentified risk of material misstatement due to fraud. In addition, analytical procedures relating to revenue are required to be performed through the end of the reporting period. If the full year's revenue information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit.

Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. Communication among the engagement team about information or conditions that indicate potential risks of material misstatement due to fraud should continue throughout the audit.

Evaluating Significant Unusual Transactions

Additional substantive procedures that may be needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, some substantive procedures have to be performed in every audit. One of those procedures involves evaluating significant unusual transactions.

AU-C 240.32 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls by considering whether the business rationale (or lack thereof) suggests that transactions may have been entered into to perpetrate fraudulent financial reporting or conceal misappropriation of assets. In evaluating the business rationale for significant unusual transactions, the auditor may consider whether:

- The transaction is overly complex in relation to its stated purpose.
- Management is overly concerned that the transaction receives a particular accounting treatment.
- Previously unidentified related parties are involved in the transaction.
- The parties to the transaction lack substance.
- The transaction and the manner of accounting have been reviewed and approved at an appropriate level, such as by those charged with governance.

Considering the Application of Significant Accounting Principles for Bias

According to AU-C 240.29 the auditor should evaluate whether the application of significant accounting principles indicates a bias on the part of management. In particular, the auditor should consider accounting related to subjective measurements and complex transactions. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure is one way in which fraudulent financial reporting can be accomplished.

Documentation Requirements

AU-C 230.08 requires auditors to document significant audit findings or issues, the conclusions reached about such findings or issues, and significant professional judgments made in reaching those conclusions. Judging the significance of a finding or issue generally requires an objective analysis of the facts and circumstances.

Evaluation of Presentation and Disclosure

AU-C 330.26 establishes the requirement that the auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with GAAP. AU-C 330.A72 explains that evaluating the overall presentation of the financial statements, including the related disclosures, involves the following:

- Presentation in a manner that reflects the appropriate classification and description of financial information.
- The form, arrangement, and content of the financial statements, including the related notes, with respect to the:
  - Terminology used.
  - Amount of detail given.
  - Classification of items in the financial statements.
  - Basis of amounts set forth in the financial statements.

In forming an opinion on financial statements, according to AU-C 700.16, the auditor should evaluate several matters, including the following related to presentation and disclosure, as to whether:

- Significant accounting policies selected and applied are adequately disclosed.
- Information presented is relevant, reliable, comparable, and understandable.
- Disclosures enable intended users to understand the effect of material transactions and events on the entity's financial position, results of operations, and cash flows.
- Terminology used, including the title of each financial statement, is appropriate.

In this evaluation, the auditor considers the presentation, structure, and content of each of the individual financial statements presented, i.e., typically the balance sheet, income statement and statement of cash flows, as well as the overall presentation of the financial statements as a whole.

Risk Assessment Process. As part of performing risk assessment procedures to provide a basis for identifying risks of material misstatement in the financial statements, the auditor needs to consider the potential misstatements at the assertion level for disclosures. Sufficient attention to disclosures is an essential and integral part of an effective audit. In addition to misstatements in amounts and classifications, AU-C 450.04 defines misstatements to include differences between the presentation and disclosure of a reported financial statement item and the classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with GAAP and explains that they can arise from error or fraud. Among other things, examples of potential misstatements in AU-C 450.A1 include the following:

- An omission of an amount or disclosure, and
- A financial statement disclosure that is not presented in accordance with GAAP.

In other words, the misstatement can be the omission of a necessary disclosure or the improper presentation of a required disclosure.

Some have expressed concern that auditors generally give more emphasis to amounts in financial statements than to disclosures, and more emphasis to quantitative disclosures than to qualitative or narrative disclosures. Best practices indicate that timely consideration of both quantitative and qualitative disclosures is an important part of planning and performing an effective audit.

Discussion Among the Engagement Team. The discussion among the engagement team ought to include consideration of the disclosure requirements of GAAP that are particularly important to the entity in order to identify early in the audit the areas in which there may be risks of material misstatement related to disclosures. Matters that might be discussed include the following:

- New accounting standards or other new financial reporting requirements that might result in significant new or revised disclosures.
- Changes in the entity's activities, environment, or financial condition that might result in significant new or revised disclosures.
- Particular transactions, such as a significant business combination or disposal of a segment of the business during the current period, that might result in significant new or revised disclosures.
- Disclosures for which in prior audits it has been difficult to obtain sufficient appropriate evidence.

With respect to risks of material misstatement due to fraud, the discussion ought to include consideration of the risk that management might intentionally present disclosures that are not clear and understandable or otherwise misleading, or omit necessary disclosures.

Particular Aspects of Risks of Material Misstatement Related to Disclosure. Some risks of material misstatement related to disclosure raise particular difficulties for the auditor, such as disclosure information derived from sources that are not part of the general ledger system, including qualitative disclosures.

Examples of disclosures that might include information from systems or processes that are not part of the general ledger system include the following:

- Valuation reports for assets recorded at cost for which fair value must be disclosed.
- The nature of related party relationships and other information deemed necessary to understand the effects of the transactions in the financial statements.
- How and why the entity uses derivative instruments.
- The description of investment policies and strategies of a pension plan.
- The description of accounting policies and the nature of changes in such policies.

This type of disclosure information can be either quantitative, such as a fair value amount, or qualitative, such as the nature of related party relationships.

Information from systems or processes that are not part of the general ledger system might not be subject to controls as rigorous as those that apply to the transactions and events recorded in the general ledger. Also, qualitative disclosures are subject to nuances in language that can be difficult to evaluate for clarity and understandability. Thus, there may be a greater risk of material misstatement of this type of disclosure information.

Further Procedures. Similar to the audit approach for account balances and transactions, the auditor uses assertions to consider the different types of potential misstatements that might occur in presentation and disclosure of financial statements, and to plan further procedures to obtain reasonable assurance of detecting them.

Assertions About Presentation and Disclosure. AU-C 315.A128c describes the following assertions about presentation and disclosure:

- *Occurrence and rights and obligations.* Events, transactions, and other matters disclosed have occurred and pertain to the entity.
- *Completeness.* The financial statements include all disclosures that should have been included.
- *Classification and understandability.* Disclosures are expressed clearly and financial information is presented and described appropriately.
- *Accuracy and valuation.* Financial and other information included in the financial statements are disclosed fairly at appropriate amounts.

Materiality Considerations Related to Disclosure. Materiality is an important consideration in designing and performing further procedures pertinent to presentation and disclosure, and in assessing whether disclosures are material. Materiality is particularly important in relation to the completeness assertion—obtaining evidence that all disclosures that should have been included in the financial statements have been included. Immaterial disclosures generally need not be included in financial statements.

Using the current concept of materiality in U.S. GAAP, information, including presentation-and-disclosure information, is material if omitting or misstating it could influence decisions that users make on the basis of using an entity's financial information. That materiality concept recognizes that both qualitative and quantitative factors influence materiality judgments, and it applies to judgments about both qualitative and quantitative disclosure information.

In September 2015, the FASB issued a proposed ASU, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*. The proposed ASU indicates that materiality with respect to disclosure is applied

to both quantitative and qualitative disclosures both individually and in the aggregate in the context of the financial statements taken as a whole. The proposed ASU also explains that materiality is a legal concept. That concept has been defined by the U.S. Supreme Court. In other words, the FASB proposal clarifies that materiality for accounting purposes is the same as the legal definition and that it includes both quantitative and qualitative aspects. Applying that legal definition (as defined by the U.S. Supreme Court) to disclosure in financial statements means that disclosures generally should be evaluated as material based on whether there is a substantial likelihood that the omitted or misstated disclosure would have been viewed by a reasonable resource provider (investor, lender, etc.) as having significantly altered the total mix of information available in making a decision. Best practices indicate that the proposed references to the legal definition of materiality would not have a substantial impact on GAAP.

The proposed ASU would also clarify that omitting a disclosure of immaterial information would not be considered an accounting error. Furthermore, the proposed ASU notes that possible future amendments may be made to each disclosure requirements section in the Accounting Standards Codification to indicate that disclosures are required if they are material and eliminate language that would imply that immaterial disclosures may be required.

In designing further procedures related to disclosure, the auditor needs to make a preliminary determination of the disclosure information that has a substantial likelihood of influencing the decisions of users of financial statements by significantly altering the total mix of information available. This preliminary determination has to include qualitative as well as quantitative disclosures. For example, significant accounting policies that would be material could include those that affect ratios and trends that users regard as important considering the nature of the entity's activities and operations, such as net leverage or the proportion of operating versus investment income for a financial services company, or the proportion of program versus administrative and solicitation expenses for a nonprofit entity.

During the audit, as further procedures are performed, the auditor needs to accumulate and assess the misstatements in disclosures identified, and assess the effect both individually and in the aggregate on the financial statements. Relevant considerations include whether account balances and transactions or events are appropriately aggregated or disaggregated and clearly described, and whether related disclosures are relevant and understandable. Also, the auditor should consider whether the overall presentation and disclosure is misleading because of management bias. For example, does management omit or inadequately describe matters that users would regard as negative or give undue emphasis to matters users would regard as positive?

Use of an Auditor's Specialist for Disclosure Information. The auditor needs to determine whether particular disclosures require the involvement of an auditor's specialist. Some disclosure information, particularly information from systems or processes that are not part of the general ledger system, may necessitate the use of an auditor's specialist. Disclosure-related assertions that often involve use of specialists are those concerning accuracy and valuation. For example, financial assets for which there is no readily determinable fair value may be valued using a discounted future cash flow model. In such circumstances, the auditor may need to ask a valuation specialist to evaluate the appropriateness of the model and the underlying assumptions, and assist in determining the related note disclosures. Another related example is the need to evaluate the adequacy of the description of risks arising from complex financial instruments.

Disclosure Matters Related to the Financial Reporting Process. AU-C 315.19 requires the auditor to obtain an understanding of the information system, including the related business processes relevant to financial reporting. Among other things, AU-C 315.19 identifies the financial reporting process, including disclosures, as one of the areas of necessary understanding. The auditor needs to identify the processes that management uses to identify and prepare required disclosures, including disclosures containing information from systems and processes that are not part of the general ledger system.

Risks of material misstatement related to disclosure occur in the financial reporting process because the data gathering and preparation process for disclosures is often started near the end of the process, and involves important steps after the closing process that are often less susceptible to effective controls. Also, for many nonpublic companies, the financial reporting process is less structured and formal, particularly for information not obtained from the general ledger system. The auditor needs to design and perform further procedures responsive to these risks of potential material misstatement in disclosures. These procedures ought to include agreeing or

reconciling the disclosure information with the underlying accounting records and with information from systems and processes that are not part of the general ledger system.

Disclosures Requiring Special Audit Consideration. The auditor needs to identify areas of the financial statements, including related disclosures, for which special audit consideration is necessary. These areas often include, but are not limited to, related party relationships and transactions, going-concern related issues, complex or new financial instruments, and significant unusual transactions. These are often areas with a higher risk of potential misstatement, including disclosure-related misstatements. These risks may be considered to be significant risks that require special audit consideration.

Related party relationships and transactions, for example, often involve risks of material misstatement related to the completeness and understandability of disclosure. Management of a nonpublic company may be sensitive about disclosure concerning related parties, but FASB ASC 850 requires disclosure of the nature of the relationship involved and information deemed necessary to an understanding of the effects of the transactions on the financial statements. In some cases, the name of the related party has to be disclosed. There have been instances in which notes to financial statements on related parties have been prepared in a manner that obscures the relationship and the effect on the financial statements. The auditor needs to carefully consider the risks of material misstatement in planning and performing further procedures for disclosure areas, such as related parties and related party transactions, that are deemed to require special audit consideration.

Summary of Planning and Performing Audit Procedures for Presentation and Disclosure. An appropriate audit approach to planning and performing audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with GAAP can be summarized as follows:

- Make a preliminary determination of the disclosure information that is material, considering both quantitative and qualitative matters.
- As part of performing risk assessment procedures, including during the discussion of the engagement team, identify potential material misstatements in disclosures at the assertion level that could arise due to error or fraud.
- Plan and perform further procedures designed to detect whether material misstatements have occurred at the assertion level in material areas of disclosure that are responsive to the risks of material misstatement. As part of planning and performing procedures, consider whether:
  - Particular disclosures require the involvement of an auditor's specialist.
  - Particular disclosures require special audit consideration.
- Further audit procedures related to disclosures ought to include the following:
  - Procedures for testing the gathering of disclosure information as part of the financial reporting and closing process, including information from systems and processes that are not part of the general ledger system.
  - Procedures to agree or reconcile disclosure information with the underlying accounting records and systems and processes that are not part of the general ledger system.

ANALYTICAL REVIEW AND REVIEW OF WORKPAPERS

Analytical Review

Introduction and Authoritative Literature. AU-C 520.06 requires the use of analytical procedures in the final review stage of the audit. The purpose of analytical procedures at this stage is to assist the auditor in assessing the validity of the conclusions reached, including the opinion on the financial statements. In other words, the auditor uses analytical procedures at this stage to assess whether the financial statements make sense based on the knowledge and understanding obtained during the audit. Are the relationships depicted in the financial statements reasonable based on the auditor's knowledge of the client, its operations and industry, and other information obtained in performing the audit?

Objective and Requirements. When performing a final analytical review, the auditor's objective is to design and perform analytical procedures to assist in reaching an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity.

The requirement that should be followed to achieve that objective are summarized in Exhibit 1-16.

Exhibit 1-16

Requirement for Analytical Procedures

Requirement	AU-C Reference
Design and perform analytical procedures near the end of the audit that assist with forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity.	AU-C 520.06

* * *

Overall Review. AU-C 520.A25 states that this overall review would generally include consideration of:

a. the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit, and

b. unusual or unexpected balances or relationships that were not previously identified.

In other words, the auditor needs to consider whether the information gathered during the audit provides a sufficient understanding of unusual or unexpected financial statement relationships. This assessment includes consideration of those matters identified during preliminary analytical procedures, as well as matters that become apparent for the first time during the final review stage. When the auditor does not have a sufficient understanding of the cause of an unusual or unexpected relationship, the auditor may need to revise the risk of material misstatement and apply additional audit procedures.

Preliminary analytical procedures are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures are used to consider the adequacy of the procedures performed. Although the objective of applying the procedures may differ, the analytical procedures actually applied may be very similar or identical. At the planning stage, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be applied to amounts after audit adjustment. Thus, in the final review, a simple comparison to prior period amounts at the financial statement level is normally effective.

One common form of documentation is referred to as a *flux analysis*. A flux analysis is a narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or

unexpected relationships to other financial statement line items in the current period. A flux analysis is required by AU-C 520, but recommend it as a convenient means of documenting the thought process that is required by the standard. A flux analysis is often performed during the risk assessment process at the start of the audit. If there are relatively few adjustments made during the audit, the initial flux analysis can be updated rather then reperformed in the final review.

AU-C 240 requires the auditor to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Those procedures should be performed through the end of the reporting period. If the full year's revenue information is available during audit planning, the required procedures can be performed during preliminary analytical procedures and updated during the final analytical review stage of the audit.

Review of Workpapers

Introduction and Authoritative Literature. The review of workpapers near the conclusion of the engagement has two stages: (a) detailed review of the audit work of staff assistants, and (b) a higher-level supervisory review. Although an audit senior usually reviews the work of staff assistants and a manager or partner usually makes a supervisory review, there is considerable variation in practice. For example, in some small business engagements, the audit senior may be the only staff performing the engagement.

Specific workpaper review practice may vary with client size and circumstances, the size of the audit team, and firm policies and practices on engagement administration. When clients are larger or more complex or when there are large audit teams, there may be further subdivision of the detailed and supervisory reviews.

Authoritative pronouncements establish only broad requirements for supervision and review. AU-C 220.18–.19 requires the engagement partner to take responsibility for review of the work performed in accordance with the firm's review policies and procedures. Based on the review of audit documentation and discussion with the engagement team, on or before the date of the auditor's report, the engagement partner should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's report to be issued.

Objectives and Requirements. The objectives of the auditor when performing the review of the workpapers are to—

- assess whether the documentation prepared provides evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements, and
- implement quality control procedures at the engagement level that provide reasonable assurance that the audit complies with professional standards and applicable legal and regulatory requirements and the auditor's report is appropriate in the circumstances.

The requirements that should be followed to achieve those objectives are summarized in Exhibit 1-17.

Exhibit 1-17

Requirements for Workpaper Review

Requirements	AU-C Reference
Detailed and Supervisory Reviews	
Record who reviewed the work and the date and extent of that review when documenting the nature, timing, and extent of procedures.	AU-C 230.09
Engagement Performance	
The engagement partner should ensure that reviews are being performed in accordance with the firm's review policies and procedures.	AU-C 220.18

Requirements	AU-C Reference
Based on the review of audit documentation and discussion with the engagement team, on or before the date of the auditor's report, the engagement partner should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's report to be issued.	AU-C 220.19
The engagement partner should take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters.	AU-C 220.20
The engagement partner should be satisfied that— • Members of the engagement team have followed consultation policies during the course of the engagement. • The nature and scope of the consultation is agreed upon with the party consulted and the conclusions resulting from such consultations are understood by the party consulted. • The conclusions resulting from such consultations have been implemented.	AU-C 220.20
For those audit engagements, if any, for which the firm has determined that an engagement quality control review (EQCR) is required, the engagement partner should— • Ascertain that an engagement quality control reviewer has been appointed. • Discuss significant findings or issues that arose during the audit engagement with the engagement quality control reviewer. • Ensure that the auditor's report is not released before the EQCR is completed.	AU-C 220.21
The engagement quality control reviewer should perform an objective evaluation of the significant judgments made and the conclusions reached in formulating the auditor's report. This evaluation should involve— • Discussing significant findings or issues with the engagement partner. • Reading the financial statements and the proposed report. • Reviewing selected audit documentation relating to the significant judgments the engagement team made and the related conclusions it reached. • Evaluating the conclusions reached in formulating the report and considering whether the proposed report is appropriate.	AU-C 220.22
When differences of opinion occur within the engagement team, with those consulted, or between the engagement partner and the engagement quality control reviewer, the engagement team should follow the firm's policies and procedures for resolving differences of opinion.	AU-C 220.23
The auditor should document conclusions reached regarding the nature and scope of, and conclusions resulting from, consultations undertaken during the engagement.	AU-C 220.25
The engagement quality control reviewer should document: • That the procedures required by the firm's policies on engagement quality control review have been performed. • The date that the engagement quality control review was completed. • That the reviewer is not aware of any unresolved issues that would cause him or her to believe that the significant judgments made and the conclusions reached were not appropriate.	AU-C 220.26

* * *

Quality Control System. SQCS No. 8, *A Firm's System of Quality Control*, indicates at QC 10.35–.36 that a firm should establish policies and procedures that address supervision and review responsibilities. The review responsibility policies and procedures should be determined on the basis that qualified engagement team members review the work performed by other team members on a timely basis. The engagement partner may delegate parts of the review responsibility to other members of the engagement team, in accordance with firm quality control policies. The review may include consideration of factors such as the following (AU-C 220.A16):

- The work is performed in accordance with professional standards and regulatory and legal requirements.
- Significant findings and issues are raised for further consideration.
- Appropriate consultations take place and resulting conclusions are documented and implemented.
- The nature, timing, and extent of work performed is appropriate and without need for revision.
- The procedures performed support the conclusions reached and are properly documented.
- Evidence obtained is sufficient and appropriate to support the report.
- The objectives of the procedures performed are achieved.
- The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client's business and industry. (AU-C 300.A16)

The engagement partner needs to direct other team members to bring to his or her attention accounting and auditing issues raised during the audit that the team member believes are significant to the financial statements or auditor's report so that he or she may assess their significance. Engagement team members also need to be instructed to bring to the attention of appropriate individuals in the firm difficulties encountered when performing the audit, such as missing documents or client resistance in responding to inquiries or providing access to information. The work performed by each team member and the documentation of the work needs to be reviewed to determine whether the work was adequately performed and documented and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report.

Audit documentation assists the auditor in the direction, supervision, and review of the audit. Auditors are required to document *who* performed the work and *when* the work was completed. Likewise, the workpapers should indicate *who* reviewed the work and the *date* of the review. (AU-C 230.09) These requirements do not mandate any specific arrangements for engagement administration.

Audit firms need to have some mechanism to assure that significant accounting or auditing problems identified in the audit work or detailed review are brought to the attention of the supervisory reviewer. Also, QC 10.46–.48 state that firms should establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures should require that (a) conclusions reached be documented and implemented, and (b) the report not be released until the difference of opinion is resolved. Additionally, such policies and procedures should enable engagement team members to document his or her disagreement with the conclusions reached after appropriate consultation has taken place.

Detailed Review of Audit Work. The objectives of the detailed review of audit work are to assure that there is:

a. adherence to professional standards and firm policies and practices;

b. integration of results and conclusions from work on individual financial statement components; and

c. proper summarization of the results of audit tests, including significant audit findings or issues, for the attention of the supervisory reviewer and for potential reporting to the client.

In general, the reviewer should determine whether the audit documentation would permit an experienced auditor who has no previous connection with the engagement to understand (a) the nature, timing, and extent of the

auditing procedures performed, (b) the results of the audit procedures and the evidence obtained, (c) the conclusions reached on significant matters, and (d) that the audited financial statements agree or reconcile to the accounting records.

The detailed review of the current workpaper file usually includes the following:

a. For each financial statement component, review the supporting schedules to assure that:

   (1) each schedule is complete and properly headed, dated, initialed, indexed, and cross-referenced to the working trial balance;

   (2) amounts agree with the amounts in the working trial balance and have been traced to the general ledger;

   (3) the audit program has been completed, as indicated by initials, dated, indexed, the conclusion signed off, and the related workpaper schedules indicate that the procedures have been performed; and

   (4) any misstatements discovered have been properly identified, analyzed, and treated.

b. For the general section of the file and the workpapers as a whole (including the permanent file), ensure that:

   (1) any information on a workpaper for a financial statement component that is relevant to another component has been properly considered and cross-referenced;

   (2) any relevant information in the permanent file or other general files has been incorporated or cross-referenced;

   (3) any significant audit findings or issues (including related discussions with management and others) have been adequately addressed and documented; and

   (4) any unusual matters have been included in the management representation letter.

c. Preparing summary and evaluation schedules and drafting the financial statements and audit report.

AU-C 230.09 requires that the workpapers indicate who reviewed specific audit documentation and the date and extent of the review. Auditors are not required to indicate their review on each specific workpaper. However, the documentation should clearly indicate who reviewed specified elements of the audit work and when. A practical and efficient way of indicating who reviewed specified elements of the audit work and when is for the detailed reviewer to initial and date the specific workpapers reviewed.

Supervisory Review. In practice, the greatest variations in review of workpapers occur in the extent and levels of supervisory review. As explained earlier, these variations are a result of differences in client size and complexity, audit team size and qualifications, and individual firm policies and preferences for engagement administration. Generally, the supervisory review focuses more on the summary and evaluation schedules and documentation of significant audit findings or issues, and less time and attention is given to supporting workpaper schedules. It is often conducted after financial statements and the audit report have been drafted, and it is the final check on whether the audit work supports the overall conclusions on the financial statements.

Any review notes or comments from the earlier stages of review need to be satisfactorily resolved by the completion of the supervisory review. The particular practices adopted for documenting and clearing review notes are a matter of individual firm preferences in engagement administration. However, it is important that the resolution be clear and that no apparently unanswered or open matters remain in the final workpapers. Once the audit has been completed, all review points and notes need to be removed from the workpapers, as they do not constitute audit evidence.

Supervisory reviewers should document their review of specific audit documentation and when it occurred. A practical and efficient way of indicating who reviewed specified elements of the audit work and when is for the

supervisory reviewer to initial and date the specific workpapers reviewed; however, there are no requirements to do so. Some reviewers may prefer to document their review in a memo format that indicates the specific workpaper sections reviewed and associated dates. Checklists may also be used.

Review Checklists. Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of the review of the workpapers.

Sole Practitioners. Obviously, much of this discussion on the review of workpapers is not applicable to a sole practitioner with no staff. A sole practitioner of necessity has to review his or her own workpapers. Professional standards do not require that audit work necessarily be reviewed by someone other than the person who did the work. QC 10.A1 notes that the review responsibilities are not relevant when there are no staff.

That does not mean, however, that review of completed audit work is unimportant. It is still necessary to make a critical review of completed work and evaluate whether the work performed adequately supports the conclusions reached.

Tax Department Review. CPA firms with separate tax departments typically have the tax department review the tax areas of the audit workpapers and financial statements. The auditor needs to discuss with tax department personnel any knowledge they may have of matters that may affect the financial statements.

Engagement Quality Control Review. Many firms require a review of the audited financial statements, auditor's report, and other communications and reports by someone who has no other responsibility on the audit. Depending on firm policy, engagement quality control reviews may also include additional procedures, such as:

a. Looking at the checklists or memoranda that document the review by the audit senior, audit partner, and tax department.

b. Reviewing attorneys' letters and the management representation letter.

c. Reading documentation related to the significant judgments made by the engagement team and the conclusions they reached.

d. Discussing significant findings and issues with the engagement partner.

SQCS No. 8 states that a firm should establish criteria against which all audit engagements should be evaluated to determine whether an engagement quality control review (EQCR) should be performed (QC 10.38). Firms may consider the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. SQCS No. 8 indicates that a firm should establish policies and procedures that set forth the nature, timing, and extent of a quality control review. (QC 10.40) The following list represents the types of situations that may be considered in establishing EQCR criteria:

- Third-party use of the report, such as to the client's lender for financing purposes.
- High profile clients, for example, well-known individuals or entities in the local community.
- Entities subject to governmental regulations.
- New types of service for the firm; for example, the firm begins to offer prospective financial information services.
- New or complex specialized industries.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related party transactions.

- Clients that have experienced material misstatements during the current or previous engagements.
- First-time clients.
- New partners leading the engagement.

In general, any circumstance that creates an unusual or higher level of engagement risk needs to be considered in establishing EQCR criteria. Whenever an engagement is subject to a heightened level of risk, the firm may consider it prudent to have a second pair of eyes review the engagement. Regardless of whether a particular engagement meets the firm's stipulated EQCR criteria, it may be selected for EQCR based upon current year risk during engagement performance. However, the reverse situation does not hold true. That is, a firm may not choose to opt-out of performing an EQCR when an engagement meets the established EQCR criteria.

If performed, the engagement quality control review should be completed before the audit report is released (QC 10.40). Best practices suggest that an engagement quality control review be performed on each audit.

EQCR for Smaller Firms and Sole Practitioners. When sole practitioners or small firms identify engagements requiring EQCRs, a qualified individual may not be available within the firm to perform the EQCRs. In such cases, qualified external individuals or firms may be contracted to perform the function. When the firm contracts qualified external individuals or other firms, the firm should ensure that they have the appropriate technical qualifications, are objective, and adhere to the requirements of quality control standards regarding engagement quality control review procedures.

Is Workpaper Review Required before Dating the Auditor's Report? AU-C 700.41 requires that the date of the auditor's report be no earlier than the date that sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, *sufficient appropriate audit evidence* includes evidence that:

a. The audit documentation has been reviewed.

b. The financial statements, including disclosures, have been prepared.

c. Management has taken responsibility for the financial statements.

AU-C 220.19 requires that by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. Best practices indicate that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220.A17 observes that the engagement partner may review all audit documentation, but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent.

However, AU-C 220.21 notes that for those engagements for which the firm determines an engagement quality control review is required, the review should be completed prior to the release of the audit report.

AU-C 230.16 requires that the final completion of the audit file occur within 60 days of the report release date. Final completion of the audit file may include minor administrative documentation issues noted during reviews. AU-C 230.A26 emphasizes that completion of the assembly of the final audit file after the report date should not involve the performance of any new audit procedures or drawing new conclusions; however, auditors could document audit evidence that had been obtained, discussed, and agreed with by engagement team members before the date of the auditor's report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Which of the following procedures is required when evaluating the risks of material misstatement due to fraud?

    a. At the conclusion of the audit, the auditor should evaluate the aggregate results of the audit procedures to ascertain the effect on the assessment of risk determined at the beginning of the audit.

    b. Assess the risks of material misstatement due to fraud at the beginning of the audit.

    c. Analytical procedures must be performed on revenue in the planning stages of the audit, based on the revenue figures that are available.

19. Which of the following statements regarding analytical procedures is correct?

    a. Analytical procedures are applied to unaudited amounts during the conclusion of the audit.

    b. AU-C 520.06 requires the use of analytical procedures during the planning stage of the audit.

    c. Preliminary analytical procedures can be used to determine what other audit procedures need to be performed in response to the risk assessment.

    d. Information gained from performing analytical procedures on revenue should provide an understanding of common financial statement relationships.

20. Ben is using the guidance in SQCS No. 8, *A Firm's System of Quality Control* to assist him with his audit of Washington Enterprises. Which of the following is appropriate according to that guidance?

    a. The engagement partner should tell the audit staff to communicate any significant issues discovered during the audit to him/her for evaluation.

    b. The engagement partner is required to review all work performed on the engagement for adequacy.

    c. The amount of supervision on an engagement is dependent on the staffing resources, the level of engagement, and the fees the client has agreed to.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Which of the following procedures is required when evaluating the risks of material misstatement due to fraud? **(Page 371)**

    a. At the conclusion of the audit, the auditor should evaluate the aggregate results of the audit procedures to ascertain the effect on the assessment of risk determined at the beginning of the audit. [This answer is correct. At or near the completion of fieldwork, AU-C 240.34 requires the auditor to evaluate the accumulated results of audit procedures and other conditions noted during the audit to determine their effect on the auditor's assessment of risks made previously. Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud.]

    b. Assess the risks of material misstatement due to fraud at the beginning of the audit. [This answer is incorrect. Assessing the risks of material misstatement due to fraud is an ongoing process that should occur throughout the audit. Fraud risks may be identified during the engagement acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, when assessing the risks of material misstatement of the financial statements due to error or fraud, when performing further audit procedures to respond to assessed risks, or when communicating with management or others.]

    c. Analytical procedures must be performed on revenue in the planning stages of the audit, based on the revenue figures that are available. [This answer is incorrect. AU-C 240.34 requires performance of analytical procedures relating to revenue through the end of the reporting period. If the full year's revenue information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit.]

19. Which of the following statements regarding analytical procedures is correct? **(Page 377)**

    a. Analytical procedures are applied to unaudited amounts during the conclusion of the audit. [This answer is incorrect. At the planning stage of the audit, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be applied to amounts after audit adjustment.]

    b. AU-C 520.06 requires the use of analytical procedures during the planning stage of the audit. [This answer is incorrect. AU-C 520.06 requires the use of analytical procedures in the review stage of the audit to assess whether the financial statements make sense based on the knowledge and understanding obtained during the audit.]

    c. Preliminary analytical procedures can be used to determine what other audit procedures need to be performed in response to the risk assessment. [This answer is correct. Preliminary analytical procedures are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures should be performed in response to the risk assessment.]

    d. Information gained from performing analytical procedures on revenue should provide an understanding of common financial statement relationships. [This answer is incorrect. AU-C 240 requires the auditor to perform analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Those procedures should be performed through the end of the reporting period.]

20. Ben is using the guidance in SQCS No. 8, *A Firm's System of Quality Control* to assist him with his audit of Washington Enterprises. Which of the following is appropriate according to that guidance? **(Page 380)**

    a. The engagement partner should tell the audit staff to communicate any significant issues discovered during the audit to him/her for evaluation. [This answer is correct. Per SQCS No. 8, *A Firm's System of Quality Control*, the engagement partner needs to direct other team members to bring to his attention accounting and auditing issues raised during the audit that the team member believes are significant to the financial statements or auditor's report so that he may assess their significance. Team members need to also be instructed to bring to the attention of appropriate individuals in the firm difficulties encountered when performing the audit, such as missing documents or client resistance in responding to inquiries or providing access to information.]

    b. The engagement partner is required to review all work performed on the engagement for adequacy. [This answer is incorrect. The work performed by each team member and the documentation of the work needs to be reviewed to determine whether the work was adequately performed and documented and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report. The engagement partner may delegate parts of the review responsibility to other members of the engagement team, in accordance with firm quality control policies.]

    c. The amount of supervision on an engagement is dependent on the staffing resources, the level of engagement, and the fees the client has agreed to. [This answer is incorrect. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client's business and industry. The amount of supervision is not dependent on the engagement fees.]

Lesson 2: Preparing and Drafting an Auditor's Report and the Required Communication with the Client

INTRODUCTION

Near the end of the audit, auditors are required to evaluate whether the accumulated results of the auditing procedures performed provide a high level of assurance that the financial statements, as a whole, are free of material misstatement. That evaluation includes consideration of misstatements discovered during fieldwork, including whether identified misstatements are indicative of possible fraud, which is further discussed later in this section. Additionally, AU-C 450.11 requires that the individual and combined effects of all uncorrected misstatements be considered to determine whether they are material to the financial statements taken as a whole. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. Related matters that may also be considered at this stage of the audit are overall analysis of audit time and consultation with others on complex technical issues.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the categories for the evaluation and summarization of the misstatements discovered in fieldwork and the documentation the auditor should clarify.
- Determine the auditor's obligations in relation to drafting the financial statements and preparing the auditor's report.

Objectives and Requirements

AU-C 450, *Evaluation of Misstatements Identified During the Audit*, provides guidance for evaluating misstatements. In addition, certain requirements relating to evaluating whether misstatements are indicative of fraud in AU-C-240, *Consideration of Fraud in a Financial Statement Audit*, are also discussed in this section.

The objectives of the auditor when evaluating misstatements identified during the audit are to evaluate the effect of identified misstatements on the audit and of any uncorrected misstatements on the financial statements. The requirements that should be followed to achieve those objectives are summarized in Exhibit 2-1.

Exhibit 2-1

Requirements for Evaluation of Misstatements Identified During the Audit

Requirements	AU-C Reference
Accumulate misstatements identified during the audit, except for those that are clearly trivial.	AU-C 450.05
Determine if the overall audit strategy and audit plan need to be revised if: • The nature and reasons for identified misstatements indicate that other misstatements may exist that, when aggregated with misstatements already identified, could be material. • The aggregate of the misstatements identified during the audit is at or near materiality.	AU-C 450.06a
Communicate in a timely manner all misstatements accumulated during the audit with the appropriate level of management and request management to correct those misstatements.	AU-C 450.07
If, at the auditor's request, management examines a class of transactions, account balance, or disclosure and corrects detected misstatements, perform additional audit procedures to determine if other misstatements remain.	AU-C 450.08

Requirements	AU-C Reference
If management refuses to correct one or more misstatements, understand their reasons for not making the corrections and consider that when evaluating whether the financial statements as a whole are free from material misstatement.	AU-C 450.09
Before evaluating the effect of uncorrected misstatements, reassess whether materiality is still appropriate based on the entity's actual financial results.	AU-C 450.10
Determine whether uncorrected misstatements are material, individually or in the aggregate, in relation to both particular classes of transactions, account balances, or disclosures and to the financial statements as a whole, by considering— • The effect of misstatements not corrected in prior periods. • The amount, nature, and reasons for current year misstatements.	AU-C 450.11
Document the amount considered clearly trivial when accumulating misstatements; all misstatements accumulated during the audit and whether they were corrected; the conclusion about whether uncorrected misstatements are material, individually or in the aggregate; and the basis for that conclusion.	AU-C 450.12
If a misstatement is identified, evaluate whether such a misstatement is indicative of fraud. If such an indication exists, evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.	AU-C 240.35
If a misstatement is identified that is believed to be, or may be, the result of fraud and that management (in particular, senior management) is involved, reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. Also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained.	AU-C 240.36
If a conclusion is made, or is unable to be made, about whether the financial statements are materially misstated as a result of fraud, evaluate the implications for the audit.	AU-C 240.37
If, as a result of identified fraud or suspected fraud, there is question about the ability to continue performing the audit— • Determine the professional and legal responsibilities applicable in the circumstances, including whether a requirement exists to report to the person or persons who engaged the auditor or to regulatory authorities. • Consider whether it is appropriate to withdraw from the engagement. • If a decision is made to withdraw, discuss with the appropriate parties the withdrawal and the reasons for the withdrawal.	AU-C 240.38
If a lower materiality amount than that initially determined is appropriate, assess if it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate.	AU-C 320.13

* * *

Nature of Misstatements

AU-C 450.A1 explains that a misstatement can result from errors or fraud and occurs in the following circumstances:

- An inaccuracy occurs in gathering or processing data for inclusion in the financial statements.
- A financial statement element, account, or item is omitted.
- Financial statement disclosures are not in accordance with GAAP.
- Financial statement disclosures required by GAAP are omitted.
- An incorrect accounting estimate arises, such as from an oversight or misinterpretation of facts.
- Management makes unreasonable or inappropriate judgments concerning an accounting estimate or the selection or application of accounting policies.

The difference between errors and fraud is intent. Errors are unintentional misstatements of amounts or disclosures in the financial statements. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, defines fraud as an intentional act by an individual (or individuals) through the use of deception, which results in misstatement to the financial statements. Two types of financial statement misstatement may result from fraud: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Categories for Evaluation

The categories of misstatements and the format used to summarize them are matters of individual firm preference. This course uses the following classifications:

a. *Normal Closing Entries.* These are routine entries, such as adjustments of accruals or depreciation, that are made to help the client close out the books for the year. If normal closing entries are booked, they *are not misstatements* and should not be included in the summary of audit differences. Best practices also indicate that normal closing entries ordinarily are not significant findings or issues that would be subject to the documentation requirements of AU-C 230, *Audit Documentation*. Grouping closing entries in one place is more convenient for supervisory review and discussion with the client. It is necessary for the client to agree with booking these entries and accept responsibility for them because the financial statements are the client's responsibility.

b. *Audit Differences.* These are any differences noted between the accounting records and the evidence obtained during the audit. An audit difference could be any of the following:

   (1) Passed adjustment for a specifically identified misstatement.

   (2) Projected misstatement from a substantive audit sampling application.

   (3) Significant unexplained difference from an analytical procedure that is treated like a misstatement.

   (4) Difference between the client's accounting estimate and the relevant end of the auditor's acceptable range for that estimate.

Audit Differences

In discussing summarization and evaluation, the term *audit differences* is used to refer to misstatements of amounts and classification. This term was adopted because, as a practical matter, the auditor can only summarize quantitative misstatements. Other misstatements, primarily those relating to presentation and disclosure assertions, are usually judged qualitatively on an individual basis.

Types of Misstatements. AU-C 450.A3 provides the following terminology, to distinguish between the types of misstatements, which auditors may find beneficial in evaluating the effect of misstatements accumulated during the audit and communicating misstatements to management and those charged with governance:

a. *Factual Misstatement.* This is a misstatement about which there is no doubt.

b. *Judgmental Misstatement.* A judgmental misstatement is one that arises from judgments made by management related to accounting estimates that the auditor believes to be unreasonable. This type of misstatement may also arise due to the selection or application of accounting principles by management that the auditor considers to be inappropriate.

c. *Projected Misstatement.* This type of misstatement is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures.

Factual misstatements are observed directly by the auditor when performing audit procedures. For example, a sales transaction recorded in the wrong accounting period is a factual misstatement. Judgmental and projected misstatements, while not actually observed by the auditor, arise from procedures performed during the audit. For example, the auditor may determine through performance of procedures to evaluate the adequacy of the allowance for bad debts that the entity's bad debt expense is unreasonable given historical trends, resulting in the identification of a judgmental misstatement. Additionally, the auditor may determine the amount of a projected misstatement based upon the results of a sampling application.

Communication and Correction of Misstatements. AU-C 450.07 requires the auditor to communicate to management on a timely basis all misstatements accumulated during the audit, other than clearly trivial ones. AU-C 450.A3 suggests that distinguishing the type of misstatements identified is beneficial to the communication with management and those charged with governance. AU-C 450.07–.09 also requires the following related to the communication and correction of misstatements:

- Ask the appropriate level of management to correct accumulated misstatements. (Accumulated misstatements do not include those that are clearly trivial.)

- After the detection of a misstatement, the auditor may request management to examine account balances, transactions classes, or disclosures and make appropriate corrections. For example, if the auditor identified a misstatement while testing the cost prices of raw materials inventory and extrapolated the misstatement as an amount material to the raw materials account balance, the auditor may ask management to examine the entire raw materials account balance to identify and correct any misstatements. Additionally, when the auditor detects a judgmental (likely) misstatement involving an estimate, the auditor may request management to review the assumptions and methods it used in developing the estimate. In those situations and following the correction of detected misstatements, the auditor should perform additional procedures to determine whether misstatements still remain.

- If management decides not to correct some or all of the misstatements, the auditor should obtain an understanding of management's reasons for not correcting the misstatements and take that into account when making the qualitative considerations discussed later in this course. The auditor should also consider the implications for the audit report. In addition, uncorrected misstatements are significant audit findings under AU-C 260.13 and should be communicated to those charged with governance.

When communicating accumulated misstatements, AU-C 450.A6 indicates that the appropriate level of management is the one that has responsibility and authority to evaluate misstatements and take the necessary corrective action. Best practices suggest that management be strongly encouraged to correct all identified misstatements, including those communicated by the auditor. AU-C 450.A8 observes that correcting all misstatements enables management to maintain accurate books and records and diminishes the risks of future financial statements becoming materially misstated because of the cumulative effect of immaterial uncorrected misstatements in prior years. The auditor should be aware that laws or regulations might restrict communication of certain misstatements to management or others within the entity. As explained in AU-C 450.A7, laws or regulations might specifically prohibit a communication or other action that might prejudice an ongoing investigation by an appropriate authority.

Evaluating Audit Differences

Uncorrected Misstatements. The auditor determines materiality levels in conjunction with planning the audit. Prior to evaluating the effect of uncorrected misstatements, the auditor should reevaluate whether materiality remains appropriate in light of the entity's actual financial results (AU-C 450.10). That reevaluation of materiality should be made before performing the procedures discussed later in this course.

AU-C 700.14 states that the auditor should conclude whether the financial statements taken as a whole are free of material misstatement. AU-C 450.11 requires that the individual and aggregate effects of all uncorrected misstatements be considered to evaluate whether the financial statements are fairly stated. In making that evaluation, the auditor should consider both quantitative and qualitative factors, as well as the effect on prior periods. The summarization and evaluation of audit differences can be complex and best practices suggest that the auditor include consideration of the following factors:

- *Nature.* For example, goods shipped but not billed, accounts payable not recorded, and assets expensed instead of capitalized.

- *Cause.* For example, arithmetic or mechanical mistake, inappropriate application of an accounting principle because of misunderstanding, intentional use of an accounting principle that is not generally accepted, and whether misstatements are isolated or related to a common cause.

- *Amount.* The dollar amount of the difference and whether the difference is an overstatement or understatement.

- *Effect.* The financial statement components affected by the difference (for example, income before taxes and working capital). (Also, consider the effect on compliance with loan covenants, such as maintaining certain operating ratios, or similar issues.)

The auditor communicates to management on a timely basis all misstatements accumulated during the audit, other than clearly trivial ones. For many small nonpublic companies, management will have corrected all nontrivial misstatements and remaining uncorrected misstatements will be limited. Generally, management will record factual misstatements. For judgmental misstatements, management often will challenge the auditor's assumptions about the misstatement and resolve any differences in those assumptions to determine if an adjustment should be made. For projected misstatements, management normally evaluates the population to determine the actual misstatements in the population to eliminate the projection element.

In considering the quantitative effects of misstatements, misstatements also need to be combined in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, the misstatements materially misstate the financial statements taken as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals (for example, current assets, current liabilities, or gross profit).

The application and other explanatory material related to evaluating the effect of uncorrected misstatements included in AU-C 450 explains that before considering the combined effect of uncorrected misstatements, the auditor considers each misstatement separately to evaluate the following matters:

- Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including whether materiality levels for that particular class of transactions, account balance, or disclosure, if any, has been exceeded.

- The effect on the group audit opinion, if the audit is conducted under AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, of any uncorrected misstatement identified by the group engagement team or communicated by the component auditors.

- The effect of considering the individual misstatement on the financial statements taken as a whole, including whether it is appropriate to offset misstatements. For example, it may be appropriate to offset

misstatements of items within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate. If the misstatement of an individual financial statement amount causes the financial statements as a whole to be materially misstated, auditors need to exercise caution before aggregating that misstatement with misstatements in other financial statement components. It is unlikely that the effect of an individually material misstatement can be offset against other misstatements that diminish its effect on important financial statement totals or subtotals in order to justify that, as a whole, the financial statements are not materially misstated. For example, it is not appropriate for a material misstatement of revenue to be netted against an offsetting misstatement of expenses, even though the aggregate effect on net income is not material.

- The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements. AU-C 450.11 states that in determining whether uncorrected misstatements are material (individually or in the aggregate), the auditor should consider the effect on the current period's financial statements of those prior period misstatements.

Clearly Trivial Misstatements. Some auditors set an amount below which detected misstatements need not be accumulated on the summary of audit differences (often referred to as adjustments passed at the workpaper level). AU-C 450.05 indicates that the auditor is required to accumulate misstatements identified during the audit, *except those that are clearly trivial*. AU-C 450.A2 goes on to explain that *clearly trivial* does not mean the same thing as not material. Misstatements that are clearly trivial are inconsequential in amount, whether considered individually or in the aggregate and whether judged by any criteria of size, nature, or circumstance. Clearly trivial matters are a wholly different order of magnitude (smaller) than materiality determined in accordance with AU-C 320. If there is any uncertainty regarding an item meeting the classification of clearly trivial, the matter is not considered to be clearly trivial.

When determining whether the amount of a misstatement meets the clearly trivial criteria, be careful not to net proposed adjustments at the workpaper level. For example, assume the auditor has determined that only misstatements greater than $500 need to be accumulated on the summary of audit differences. If the auditor has a misstatement that overstates income by $10,000 and a misstatement that understates income by $10,500, both misstatements need to be included on the summary of audit differences.

Evaluating Estimates. The result of auditing an accounting estimate is often an acceptable range in the auditor's mind for the estimate. AU-C 540 states that an accounting estimate may be evaluated by reviewing subsequent events; testing management's methods, assumptions and data; or developing a point estimate or a range. If the client's estimate is unreasonable based on the auditor's evaluation, then the difference between the client's estimate and the auditor's estimate would be considered a judgmental misstatement. (When the auditor's estimate is a range, the amount of the misstatement is the difference between the client's estimate and the closest end of the auditor's range.)

AU-C 540.21 requires the auditor to review judgments and decisions made by management when making accounting estimates to determine if there are any indicators of possible management bias. If management, for example, always chooses estimated amounts for the valuation of assets that are at the low end of the auditor's range of acceptable amounts, the combined effect could result in a material misstatement of income. In that case, the auditor would consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates taken as a whole. The auditor might consider whether management's estimates were clustered at one end of the auditor's range of acceptable amounts in the prior year and at the other end in the current year. That could indicate the possibility that management is using accounting estimates to manage earnings. If the auditor believes that is the case, he or she should consider communicating the matter to those charged with governance.

AU-C 240.32 requires the auditor to review accounting estimates for biases that could result in material misstatement due to fraud. If the auditor identifies possible bias, the auditor should reevaluate the accounting estimates taken as a whole.

Different Materiality Levels for Different Amounts, Subtotals, or Totals. The auditor makes more than one determination related to materiality during an audit engagement. A judgment is made about a single materiality amount for the financial statements taken as a whole known as planning materiality. In addition to planning materiality, the auditor determines whether there are particular financial statement items for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Also, to achieve the objective of performing the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements, the auditor establishes a performance materiality amount at the individual account balance, class of transaction, or disclosure level.

The auditor also considers materiality when evaluating audit differences at the conclusion of the engagement. During this evaluation, the auditor considers the effect of misstatements on specific amounts, subtotals, or totals in financial statements. In this case, it is possible to use a larger amount in evaluating the effect on certain amounts, subtotals, or totals than on others. For example, an auditor might conclude that the combined effect of misstatements on pretax income was material at $10,000, but that the combined effect of misstatements might reach $20,000 before being material to equity. The "Audit Difference Evaluation Form" discussed later in this course is designed to accumulate audit differences by various financial statement subtotals to accommodate the auditor's consideration of the effect of misstatements noted.

However, exclusive reliance on a quantitative amount or percentage relationship for determining materiality is not appropriate. Qualitative factors also need to be considered. AU-C 320, *Materiality in Planning and Performing an Audit*, includes a discussion about materiality in the context of an audit engagement. AU-C 320.06 explains that while it is not practicable to design audit procedures to detect misstatements that are material solely due to qualitative considerations, the auditor considers the size and the nature of uncorrected misstatements, as well as the circumstances related to their occurrence, when evaluating the effect of misstatements on the financial statements. According to AU-C 320.13, if, as the audit progresses, the auditor concludes that lower materiality levels than the amounts determined during audit planning are appropriate, the auditor should reconsider the related levels of performance materiality and the sufficiency of the further audit procedures that were performed. AU-C 450.06 indicates for the auditor to consider whether misstatements identified as the audit progresses, require revision to the overall audit strategy and audit plan. In making that determination, the auditor should consider whether (a) the nature of identified misstatements and the circumstances related to their occurrence indicate that other misstatements may exist, that when aggregated with misstatements already accumulated, could be material, or (b) the misstatements accumulated during the audit approaches materiality levels determined in accordance with AU-C 320 (that is, planning and/or performance materiality).

Qualitative Considerations. Establishing a quantitative threshold for materiality is only the starting point for an overall evaluation of whether identified misstatements are material. Quantitative thresholds, such as dollar amounts or percentages of financial statement components, are useful for making a preliminary determination that misstatements below that amount probably are not material to the financial statements taken as a whole. However, an auditor's overall judgment about whether a misstatement is material may be influenced by qualitative considerations as well as quantitative considerations. The consideration of qualitative factors may cause the auditor to conclude that a quantitatively small misstatement is material to the financial statements. AU-C 450.A23 indicates that some misstatements surrounding circumstances (qualitative considerations) may cause the auditor to conclude they are material, individually or when aggregated with other misstatements, even if they are lower than the amount previously designated as material to the financial statements as a whole. The following are examples of qualitative factors that might be considered:

a. *Effect on Other Financial Statement Components.* Some misstatements may not be significant by themselves but could result in events or conditions that materially affect the financial statements. For example, in addition, some misstatements, although not individually significant, may be pervasive to the financial statements (that is, affecting numerous financial statement amounts, subtotals, or totals).

b. *Effect on Trends, Especially Trends in Profitability.* A misstatement might be immaterial to net income for the current period but material to the overall trend of earnings, such as a misstatement that reverses a downward trend of earnings or changes a loss into income. Also, a misstatement might mask a change in earnings or other trends, especially in the context of general economic and industry conditions.

c. *Significance of the Financial Statement Element or Portion of the Entity's Business Affected by the Misstatement.* For example, a misstatement affecting recurring earnings might be considered material whereas a misstatement of the same amount involving a nonrecurring charge or credit might not be considered material. Similarly, a misstatement affecting a portion of the client's business that has been represented as significant to the entity's future operations or profitability might be more material than a misstatement of the same amount affecting another portion of the business.

d. *Effect on Compliance.* A misstatement might affect the entity's compliance with loan covenants, other contractual agreements, or regulatory provisions. For example, a small misstatement affecting working capital might be material if correcting it would reveal a default under a debt covenant.

e. *The Existence of Statutory or Regulatory Requirements Affecting Materiality Thresholds.* Deficiencies in disclosures of related-party transactions or those required by statute or regulatory authority might be considered material even though similar amounts for more routine items might be considered immaterial.

f. *Effect on Management's Compensation.* A misstatement might affect management's compensation (for example, meeting an earnings target might trigger a bonus).

g. *Incorrect Selection or Application of Accounting Policy.* A misstatement related to the incorrect selection or application of an accounting policy may have a material effect on future periods' financial statements even though the effect on the current period is immaterial.

h. *Effect on Ratios.* A misstatement may alter ratios used to evaluate the entity's financial position, results of operations, or cash flows.

i. *Effect on Segment Information.* A misstatement may affect a segment presented in the financial statements that plays an important role in the business.

j. *Known Previous Communications to Users.* A misstatement may significantly alter information previously communicated to users. For example, the misstatement may impact a forecasted earnings amount that was previously communicated.

k. *Involvement of Particular Parties.* The misstatement is related to transactions involving particular parties. For example, the external parties to the transaction are related to members of management or the board of directors.

l. *Significance of Omitted Information That Is Not Required.* The omission of information not specifically required by the applicable financial reporting framework may, in the auditor's professional judgment, be important to the users' understanding of the financial position, financial performance, or cash flows of the entity.

m. *Effect on Other Information in Documents Containing Audited Financial Statements.* The misstatement may impact other information that is communicated in documents containing the audited financial statements that may be utilized by users of the financial statements. For example, the misstatement might impact information presented in a "Management's Discussion and Analysis" that might reasonably be expected to influence the economic decisions of users.

n. *Sensitivity of the Circumstances.* For example, implications of misstatements involving fraud, possible instances of noncompliance with laws or regulations, violations of contractual provisions, or conflicts of interest could be significant.

o. *The Effects of Misclassifications.* The effects of misclassifications could be significant to the financial statement users, for example, a misclassification between operating or recurring income and nonoperating or nonrecurring income.

p. *Significance of the Misstatement or Disclosures in Relation to Reasonable User Needs.* For example, a misstatement that affects equity amounts could be material to creditors of a private company, or a

misstatement could have a significant effect on the calculation of purchase price if the entity is being acquired.

q. *Character of the Misstatement.* Audit differences are often determined with varying degrees of precision and objectivity. Some differences, such as factual (known) misstatements, can be precisely quantified. Others involve a degree of subjectivity through estimation, allocation, or uncertainty. The auditor needs to be cautious about offsetting very precise differences (sometimes referred to as "hard" differences) with much less precise differences (sometimes referred to as "soft" differences). For example, a large sales cutoff error might be individually material even if it could be offset by an estimated overage in the allowance for inventory obsolescence. In that situation, the auditor may recommend that the client book an adjustment for the cutoff error and not book an adjustment for the other audit difference.

r. *Motivation of Management.* Misstatements may indicate a possible pattern of bias by management in the development of accounting estimates. Misstatements may also be caused by management's continued unwillingness to correct weaknesses in the entity's internal control system or intentional decision not to follow GAAP or an OCBOA.

s. *Offsetting Misstatements.* An individually significant misstatement may be offset by a different misstatement that is also individually significant. Auditors need to use caution when aggregating individually significant misstatements with misstatements in other financial statement components.

t. *Potential Effect on Future Periods.* A misstatement that is currently immaterial may have a material effect in future periods because, for example, of a cumulative effect or a favorable (or unfavorable) turnaround effect.

u. *Cost of Making the Correction.* On one hand, it may not be cost-beneficial for management to develop a system to calculate and correct small misstatements. On the other hand, if there is little cost to calculate and record immaterial corrections, failure to do so may be an indication of management motivation to manage earnings.

v. *Risk That Possible Additional Undetected Misstatement Would Affect the Evaluation.*

If the auditor believes a misstatement is, or may be, the result of fraud, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, even if the effect of the misstatement is not material to the financial statements.

Risk of Possible Undetected Misstatements and Overall Evaluation. AU-C 450.A5 indicates that even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor recognizes that there is a risk that the financial statements may be materially misstated due to further undetected misstatements. If combined uncorrected misstatement is very close to the amount an auditor considers material to the financial statements taken as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers $20,000 material and uncorrected misstatement is $5,000, the risk of further misstatement of $15,000 may be considered acceptably low. If combined uncorrected misstatement is very close to $20,000, the risk may be considered unacceptably high. In that case, the auditor needs to perform additional procedures or determine that the entity appropriately adjusts the financial statements.

Evaluating the Existence of Fraud

According to AU-C 240.35, if the auditor identifies a misstatement, the auditor should evaluate whether it is indicative of fraud. If the auditor believes that such an indication exists, he or she should evaluate its implications for the audit, including the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an identified instance of fraud is unlikely to be an isolated occurrence. If the auditor believes or suspects that a misstatement, whether material or not, is a result of fraud and management (in particular, senior management) is involved, AU-C 240.36 indicates that the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. Additionally, the auditor should consider whether

it indicates possible collusion involving employees, management, or third parties when reconsidering the evidence previously obtained. If management is involved, questions about management's integrity may raise doubts about the auditor's ability to rely on representations made during the audit, as well as accounting records and documentation. If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit.

In some cases, the risk of material misstatement of the financial statements due to fraud is so significant that auditors question their ability to continue performing the audit. In that case, AU-C 240.38 states the auditor should determine his or her professional and legal responsibilities, such as whether a requirement exists to report the circumstances to those who engaged the auditor or, if applicable, to regulatory authorities. Additionally, the auditor should consider whether it is appropriate to withdraw from the engagement (when withdrawal is possible under applicable law or regulation). If the auditor withdraws from the engagement, he or she should (1) discuss the withdrawal and the reasons for it with the appropriate level of management and those charged with governance, and (2) determine whether they have a professional or legal requirement to report the withdrawal and the reasons for it, to those who engaged them, or to regulatory authorities. The decision to withdraw may depend on whether the identified risks call into question the integrity of management and whether management or others with oversight are diligent and cooperative in investigating the situation and taking appropriate action. Best practices indicate that auditors considering withdrawal should consult with legal counsel.

Documentation Requirements

To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. AU-C 450.12 states that the auditor should prepare documentation of the following:

- The amount below which misstatements would be regarded as clearly trivial.
- All misstatements accumulated by the auditor during the audit and whether they have been corrected by management.
- The auditor's conclusion as to whether uncorrected misstatements, individually or in the aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

The documentation of uncorrected misstatements allows the auditor to do the following:

- Separately consider the effects of factual, judgmental, and projected misstatements, including uncorrected misstatements identified in prior periods.
- Consider the aggregate effect of uncorrected misstatements on the financial statements.
- Consider the qualitative factors that are relevant to the auditor's consideration of whether misstatements are material.

A variety of workpaper formats could be used to summarize audit differences for consideration of their combined effect on the financial statements. The important point is that the summary include the documentation requirements listed later in this course. To satisfy the requirements of AU-C 450.11 discussed later in this course, the auditor could use a summary that allows for the materiality of misstatements to be evaluated both individually and in the aggregate and combines individually immaterial misstatements to evaluate the materiality of the effect on the financial statements taken as a whole.

Summary of Audit Differences

An auditor needs to combine, or aggregate, the effect on the financial statements of all uncorrected misstatements to evaluate whether the financial statements taken as a whole are materially misstated. According to AU-C 450, misstatements need to be combined in a way that enables the auditor to consider whether the misstatements in individual amounts, subtotals, or totals in the financial statements materially misstate the financial statements taken as a whole. That simply means the auditor needs to consider not only the materiality of individual misstatements, but also their combined effect on important financial statement totals or subtotals, e.g., current assets, current liabilities, gross profit, etc.

Treatment of Prior-year Waived Adjustments. Two methodologies have been used in practice to aggregate audit differences—the rollover method and the iron curtain method. Some firms use the rollover method. Others use the iron curtain method. The main difference between the two methods is how the effects of prior-period misstatements are considered. The rollover method, which is also called the "income statement method," considers the effect of all misstatements (current-period misstatements as well as prior-period waived adjustments) on current-period income. The iron curtain method, which is also called the "balance sheet method," focuses on the impact of misstatements on the audited balance sheet and considers the effect on current-period income of amounts needed to correct the balance sheet.

To illustrate, assume that at the end of the prior period, inventory was overstated by $10,000 and the client waived an adjustment to correct the misstatement. As a result, cost of sales was understated and net income was overstated by $10,000 at the end of the prior period. Assume also that at the end of the current period, inventory is overstated by $15,000. Under the rollover method, the current period balance sheet will be misstated by $15,000 while the income statement will be misstated by only $5,000 (the net effect of the $15,000 current period inventory overstatement and reversal of the $10,000 prior year overstatement). Under the iron curtain method, the impact of the prior-year waived adjustment on current-period income would not be considered. Inventory would be overstated by $15,000 and the cost of sales in the current period would be understated by $15,000. In other words, the $15,000 effect of correcting the balance sheet misstatement at the end of the current period would be used in evaluating the income effect of the waived adjustment.

The auditing standards do not provide much, if any, guidance to auditors on the appropriate approach to aggregate audit differences. AU-C 450.A25 mentions only that different acceptable approaches exist and recommends using the same evaluation approach from period to period to provide consistency.

When used as alternatives, both the rollover method and the iron curtain method have significant weaknesses. One of the weaknesses of the rollover method is that balance sheet misstatements could accumulate over multiple periods to an amount that would have a material effect on income if it were concluded in the future that recording a correction was desirable. The iron curtain method, on the other hand, can completely ignore the current-year effect on income (for example, the impact of a reversal) of misstatements detected in prior periods. Practice for nonpublic company engagements currently accepts either the rollover or iron curtain method.

Applying the Rollover and Iron Curtain Methods. The rollover method considers the relationship between equity and net income. The effect of a misstatement in opening equity usually has the opposite effect on net income, and a misstatement in ending equity usually has the same effect on net income. For example, assume the client did not record an adjustment to accrue for paid vacation leave earned by employees in the prior period. As a result, income (and equity) was overstated at the end of the prior period. The paid vacation leave was included in current-year expense when the employees took the time off and were paid for it. As a result, the prior-year misstatement had the effect of understating current-year income. However, if the client did not accrue for the paid vacation leave earned in the current year, the effect on income in the current year might be immaterial when taking into account the rollover or turnaround effect of the prior-year misstatement that was not adjusted for in the prior year.

To illustrate using the rollover method, assume the auditor prepares the following analysis of the effect of misstatements detected in the audits for 20X1 and 20X2 (excluding tax effects):

	Effect of Misstatement (Pretax)—Dr. (Cr.):		
	Liabilities	Beginning Equity	Income before Taxes
20X1:			
Failure to accrue paid vacation leave earned by employees in 20X1	$ (10,000)		$ 10,000
20X2:			
20X1 paid vacation leave expensed in 20X2		$ 10,000	$ (10,000)
Failure to accrue paid vacation leave earned by employees in 20X2	$ (10,500)		10,500
Cumulative financial statement adjustment at 12-31-X2—pretax	$ (10,500)	$ 10,000	$ 500

In the illustration, the auditor is likely to consider the effect on income in 20X2 as immaterial after considering the effect of the prior year misstatement. (In the example, ending equity at 12-31-X2 is overstated by $10,500, representing the $10,000 overstatement of beginning equity and the $500 overstatement of 20X2 income.)

Using this same example, the iron curtain method would ignore the effects of uncorrected prior year errors in determining the likely misstatement of financial statements. The reasoning is that an entry to beginning equity would be a prior-period adjustment. Because the auditor passed the adjustment for 20X1 as immaterial, it would be inconsistent to record the $10,000 as a prior-period adjustment to beginning equity. Instead, the auditor would focus on the $10,500 understatement of the ending vacation accrual in the 12-31-X2 balance sheet. Accordingly, in determining likely misstatement of the 20X2 financial statements, the auditor would, therefore, conclude that income for 20X2 is overstated by $10,500 rather than by $500.

Dual Approach Recommended. Best practices indicate that it is not appropriate to use the effect of prior year misstatements to avoid adjusting for what otherwise would be a material misstatement in the current year. For example, using the vacation liability example earlier in this course, assume the client never accrues for the vacation liability. If the client's work force does not grow significantly and salaries do not increase significantly in any given year, the effect on income in any given year might not be material when taking into account the effect of the prior year misstatement. However, over time, the actual liability could grow to be a significant amount, which could result in liabilities and equity being materially misstated. In order to correct the misstatements, the financial statements for previous years may have to be restated, which would be an embarrassing situation for the auditor. For this reason, best practices suggest that in quantifying the effect of misstatements, both the rollover and iron curtain methods be used by the auditor. As indicated earlier, the auditor should propose an adjustment to the financial statements if either method indicates a material misstatement of the current year financial statements. In the audit of a small nonpublic company, management normally depends on the auditor for certain accounting adjustments and corrects all misstatements discovered in the audit. Thus, uncorrected prior years' misstatements usually do not complicate the summarization and evaluation of misstatements.

Illustration. The effects, if any, of prior year unadjusted audit differences that impact current year assets, liabilities, or ending equity are reflected as current year audit differences on the form. That approach allows the auditor to track misstatements with ongoing balance sheet implications from period to period. Exhibit 2-2 illustrates a

completed "Audit Difference Evaluation Form" using the rollover method, assuming the following misstatements detected in the audits for 20X1 and 20X2 (using a 34% effective tax rate):

20X1:

1. Failure to accrue paid vacation leave earned by employees in 20X1	$	10,000
2. Capital equipment acquired 12-28-X1 charged to maintenance and repairs (10-year estimated useful life)		7,500
3. Unaccrued 20X1 audit fees, incurred by year end		5,000

20X2:

1. Failure to accrue paid vacation leave earned by employees in 20X2	$	10,500
2. Unaccrued 20X2 audit fees, incurred by year end		5,200
3. Excess provision for warranty costs on new product line		5,000
4. Current deferred income tax receivable netted against noncurrent deferred income tax payable		5,100

The Notes to Exhibit 2-2 explain how the form would be completed using the iron curtain method for the same set of misstatements.

Exhibit 2-2

Audit Difference Evaluation Form

Entity: *Plas-Cup, Inc.* Balance Sheet Date: *12-31-X2*

Completed by: *Mary Senior* Date: *2-27-X3*

Instructions: This form may be used to accumulate audit differences (AD) greater than the amount considered clearly trivial. This form should not include normal closing entries. At the end of the audit, evaluate all uncorrected audit differences, individually and in the aggregate, in relation to individual amounts, subtotals, or totals in the financial statements and conclude on whether they materially misstate the financial statements taken as a whole. Before evaluating the effect of uncorrected misstatements, the auditor should reassess whether materiality is still appropriate based on the entity's actual financial results. The notes following the table provide footnote explanations and a listing of qualitative considerations in evaluating materiality. The form allows for quantifying the effect of misstatements using both the rollover and iron curtain methods, as appropriate. You need to be familiar with the guidance in this section before completing this form.

				Financial Statements Effect— Amount of Over-(Under-) statement of:						
Description (Nature) of Audit Difference (AD)	**Factual (F), Judgmental (J), or Projected (P)**	**Cause**	**W/P Ref.**	**Total Assets**	**Total Liabilities[a]**	**Working Capital**	**Equity[a]**	**Income Before Taxes**	**Income Taxes[b]**	**Net Income[b]**
Failure to accrue 20X2 paid vacation	*F*	*Cash basis accounting*	*AA-4*		*(10,500)*	*10,500*	*6,930*	*10,500*	*3,570*	*6,930*
Unaccrued 20X2 audit fees	*F*	*Cash basis accounting*	*10-3*		*(5,200)*	*5,200*	*3,432*	*5,200*	*1,768*	*3,432*
Excess provision for warranty costs	*J*	*Estimate*	*AA-5*		*5,000*	*(5,000)*	*(3,300)*	*(5,000)*	*(1,700)*	*(3,300)*
Failure to reclassify current deferred income tax receivable	*F*	*Classification error*	*FF-2*	*(5,100)*	*(5,100)*	*(5,100)*				
Capital equipment expensed in 20X1[c]	*F*	*Improper accounting*		*(7,500)*			*(4,950)*	*(7,500)*	*(2,550)*	*(4,950)*

Depr. exp related to capital equipment expensed in 20X1[c]	*F*	*Improper account-ing*		*750*			*495*	*750*	*255*	*495*
Total				*(11,850)*	*(15,800)*	*5,600*	*2,607*	*3,950*	*1,343*	*2,607*
Less Audit Adjustments Subsequently Booked				—	—	—	—	—	—	—
Net Unadjusted AD—Current Year (Iron Curtain Method)				*(11,850)*	*(15,800)*	*5,600*	*2,607*	*3,950*	*1,343*	*2,607*
Effect of Unadjusted AD—Prior Years[d]								*(7,500)*[e]	*(2,550)*	*(4,950)*
Combined Current and Prior Year AD (Rollover Method)[f]				*(11,850)*	*(15,800)*	*5,600*	*2,607*	*(3,550)*	*(1,207)*	*(2,343)*
Financial Statement Caption Totals				*1,210,948*	*429,350*	*439,155*	*781,598*	*261,391*	*83,755*	*177,636*
Current Year AD as % of FS Captions (Iron Curtain Method)				*.98%*	*3.68%*	*1.28%*	*.33%*	*1.51%*	*1.60%*	*1.46%*
Current and Prior Year AD as % of FS Captions (Rollover Method)				*.98%*	*3.68%*	*1.28%*	*.33%*	*1.36%*	*1.44%*	*1.32%*

Qualitative Factors: Describe qualitative factors that entered into your evaluation of whether uncorrected accumulated misstatements are material, individually or in the aggregate, in relation to specific accounts and disclosures and to the financial statements as a whole, and the reasons why. _____

Conclusion: Based on the results of the evaluation performed above, as well as the consideration of qualitative factors, uncorrected audit differences, individually and in the aggregate, ____ do/ [✓] do not cause the financial statements taken as a whole to be materially misstated.

Notes:

[a] The impact of taxes payable is not included in this illustration for simplicity purposes.

[b] Income taxes and net income effect may be calculated in total for all audit differences combined rather than for each individual audit difference.

[c] Failure to capitalize equipment in 20X1 results in a similar understatement of assets in 20X2 because the client did not record the adjustment. To determine the net effect on the financial statements in 20X2, the amount that was not capitalized in 20X1 is offset by depreciation expense that would have been taken in 20X2 if the asset had been capitalized. (No depreciation expense was necessary in 20X1 because the asset was acquired on 12-28-X1.) The audit difference at 12-31-X2 using the rollover method is determined as follows:

	Amount of Over (Under) Statement of:		
	Assets	**Equity**	**Income**
20X1 understatement of property	$ (7,500)	$ (7,500)	
20X2 depreciation expense not taken (10-year useful life)	750	750	$ 750
20X2 audit difference—pretax	(6,750)	(6,750)	750
Tax effect (34%)		2,295	(255)
20X2 audit difference—after tax	$ (6,750)	$ (4,455)	$ 495

The audit difference at 12-31-X2 using the iron curtain method would be determined as follows:

	Amount of Over (Under) Statement of:		
	Assets	**Equity**	**Income**
20X1 understatement of property	$ (7,500)	$ (7,500)	$ (7,500)
20X2 depreciation expense not taken (10-year useful life)	750	750	750
20X2 audit difference—pretax	(6,750)	(6,750)	(6,750)
Tax effect (34%)		2,295	2,295
20X2 audit difference—after tax	$ (6,750)	$ (4,455)	$ (4,455)

d The effects, if any, of prior year unadjusted audit differences on current year assets, liabilities, and ending equity are to be reflected as current year audit differences and separately identified in the Description Column. This line is used only for prior year unadjusted audit differences that reverse in the current year under the *rollover* method that have no effect on current year assets, liabilities, or ending equity.

e The effect of unadjusted audit differences from the prior year includes reversal of prior year unaccrued vacation leave ($10,000) and reversal of prior year unaccrued audit fees ($5,000), both of which were expensed when paid during 20X2. It also includes the reversal of capital equipment additions in the amount of $7,500 not made in 20X1.

f The "Net Audit Differences" line under the iron curtain method as compared to the rollover method would be as follows.

	Iron Curtain	**Rollover**	**Difference**
Total Assets:	(11,850)	(11,850)	—
Total Liabilities:	(15,800)	(15,800)	—
Working Capital:	5,600	5,600	—
Equity:	2,607	2,607	—
Income Before Taxes:	3,950	(3,550)	7,500
Income Taxes:	1,343	(1,207)	2,550
Net Income:	2,607	(2,343)	4,950

* * *

Evaluation of Overall Materiality

The combined effect of uncorrected misstatements on various financial statement components (amounts, subtotals, or totals) should be compared to the amount that the auditor considers material to the financial statements taken as a whole. The auditor's judgments about materiality in audit planning may be different than materiality used in evaluating audit findings because it is not possible to anticipate everything that could ultimately influence judgments about materiality when evaluating audit findings at completion of the audit. For example, while performing the audit, the auditor may become aware of quantitative or qualitative factors that were not initially considered but could be important to users of the financial statements. Those factors should be considered in making materiality judgments about audit findings. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor should reconsider performance materiality and appropriateness of the nature, timing, and extent of further audit procedures. If the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that could be material when aggregated with identified misstatements, the auditor should also consider whether the overall audit strategy and audit plan need to be revised.

Analysis of Audit Time

Another aspect of the summarization and evaluation stage of an engagement is analysis of audit time. Normally, the audit time spent is recorded day by day, and when it becomes apparent that audit time for a particular financial statement component may exceed budget, prompt corrective action is necessary. Near the end of the engagement, total audit time may be summarized and evaluated.

It is beneficial for a variety of reasons to summarize and explain significant variations for the original audit time budget. Such an analysis is useful for planning for the next year and in fee discussions with the client. Also, explaining significant budget underages may be important for legal liability purposes.

Consultation on Technical Issues

The review of workpapers, particularly the summarization and evaluation of audit differences, may indicate the need to consult with someone not involved in the engagement on complex technical issues. See the requirements for workpaper review related to consultation issues at Exhibit 1-16. The fact that consultation has taken place (including the nature and scope of the consultation) and the resolution of the issue should be documented in the workpapers as required by AU-C 220.25d, but *when* consultation is necessary and *with whom* vary considerably.

Some firms designate specialists in particular industries. Some firms designate a particular person to become an expert in unusually complex areas, such as leases or pension plans. Most firms have specialists in income taxes. The extent of specialization varies with firm size and individual firm preference. Naturally, the smaller a firm is, the less likely the firm has specialists available for consultation. On particularly complex matters, outside consultation may be advisable. The AICPA, for example, has a technical information service that answers inquiries on complex accounting and auditing issues. The toll-free number for this service is (888) 777-7077.

PPC's Guide to Quality Control discusses consultation in more detail. SQCS No. 8, "A Firm's System of Quality Control," at QC 10.37, indicates that a firm should establish policies and procedures designed to provide it with reasonable assurance that consultation takes place when appropriate (for example, when dealing with difficult or contentious issues) and that various other aspects of consultation, including documentation, are sufficient and appropriate. That *Guide* can be ordered by calling (800) 431-9025 or by visiting the website at **tax.thomsonreuters.com**.

AU-C 220.20 places responsibility on the audit engagement partner to ensure that appropriate consultation is undertaken on difficult or contentious matters. Further, the engagement partner should be satisfied that—

- Members of the engagement team have followed consultation policies during the course of the engagement.

- The nature and scope of the consultation is agreed upon with the party consulted.

- The conclusions resulting from such consultations are understood by the party consulted.
- The conclusions resulting from such consultations have been implemented.
- The audit documentation includes the nature and scope of, and conclusions resulting from, consultations undertaken during the engagement.

AU-C 220.A20 notes that members of the audit engagement team also have a responsibility regarding consultation. Their responsibility is to bring to the attention of appropriate personnel matters encountered during the performance of the engagement that they believe are difficult or contentious and may require consultation. AU-C 220.A22 suggests that the engagement team may take advantage of advisory services offered by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. During his audit of Crockett Construction, Harold observes a sales transaction recorded in the wrong accounting period. This is an example of which of the following misstatements?

    a. Projected misstatement.

    b. Factual misstatement.

    c. Judgmental misstatement.

22. Which of the following statements is correct regarding the differences in how the rollover and iron curtain methods are applied?

    a. The iron curtain method considers the relationship between equity and net income.

    b. The primary difference between the iron curtain method and the rollover method is how the effects of prior-period misstatements are considered.

    c. The iron curtain method considers the effect of all misstatements.

    d. The rollover method has significant weaknesses over the iron curtain method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. During his audit of Crockett Construction, Harold observes a sales transaction recorded in the wrong accounting period. This is an example of which of the following misstatements? **(Page 392)**

    a. Projected misstatement. [This answer is incorrect. A projected misstatement is a misstatement that is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures. These types of misstatements are not actually observed by the auditor.]

    b. Factual misstatement. [This answer is correct. Factual misstatements are misstatements about which there is no doubt and are observed directly by the auditor when performing audit procedures, according to AU-C 450.A3.]

    c. Judgmental misstatement. [This answer is incorrect. Judgmental misstatements arise from judgments made by management related to accounting estimates that the auditor believes to be unreasonable. These types of misstatements are not actually observed by the auditor.]

22. Which of the following statements is correct regarding the differences in how the rollover and iron curtain methods are applied? **(Page 399)**

    a. The iron curtain method considers the relationship between equity and net income. [This answer is incorrect. The rollover method considers the relationship between equity and net income. The effect of a misstatement in opening equity usually has the opposite effect on net income, and a misstatement in ending equity usually has the same effect on net income.]

    b. The primary difference between the iron curtain method and the rollover method is how the effects of prior-period misstatements are considered. [This answer is correct. The main difference between the two methods is how the effects of prior-period misstatements are considered, as stated in AU-C 450.]

    c. The iron curtain method considers the effect of all misstatements. [This answer is incorrect. The rollover method, which is also called the "income statement method," considers the effect of all misstatements (current-period misstatements as well as prior-period waived adjustments) on current-period income. The iron curtain method, which is also called the "balance sheet method," focuses on the impact of misstatements on the audited balance sheet and considers the effect on current-period income of amounts needed to correct the balance sheet.]

    d. The rollover method has significant weaknesses over the iron curtain method. [This answer is incorrect. When used as alternatives, both the rollover method and the iron curtain method have significant weaknesses. One of the weaknesses of the rollover method is that balance sheet misstatements could accumulate over multiple periods to an amount that would have a material effect on income if it were concluded in the future that recording a correction was desirable. The iron curtain method, on the other hand, can completely ignore the current-year effect on income (for example, the impact of a reversal) of misstatements detected in prior periods.]

DRAFTING FINANCIAL STATEMENTS AND THE AUDITOR'S REPORT

Drafting Financial Statements

In many engagements, the auditor drafts or assists with drafting the financial statements. Financial statement preparation assistance is a nonattest service subject to the requirements of ET 1.295 of the AICPA *Code of Professional Conduct*.) Client management should understand that the auditor's involvement in drafting the financial statements does not change the fact that management is responsible for the financial statements. Management is expected to acknowledge its responsibility in the management representation letter. Furthermore, for the auditor to remain independent, among other things, management should agree to accept that responsibility, and the auditor should be satisfied that management has the ability to do so. The auditor's understanding with the client regarding drafting the financial statements should be documented. As explained earlier in this course, an auditor needs to discuss the representation letter with management so management understands the meaning and significance of acknowledging responsibility for the financial statements.

Management needs to also understand that the auditor's involvement in drafting the financial statements may represent a significant deficiency or material weakness in internal control that should be communicated, in writing, to management and those charged with governance. Communicating internal control related matters, including issues related to the auditor's involvement in financial statement preparation, are discussed later in this course.

Statement of Cash Flows. All the information for the statement of cash flows is derived from the other basic financial statements. Once audit procedures have been applied to the other basic statements, the statement of cash flows can be prepared. Usually, a comparative workpaper schedule is prepared to determine the amounts for the statement and to identify the sources of these amounts by cross-reference to other workpapers. Generally, no additional audit tests are necessary because the amounts have already been substantiated on the source schedules. For example, property additions and issuance of long-term debt come directly from the workpapers for those balance sheet accounts, and audit procedures will have been applied to those amounts. If an amount does not come directly from another workpaper, its calculation should be detailed on the schedule used to prepare the statement of cash flows.

Notes to Financial Statements. The notes to the financial statements are an integral part of the statements. Normally, the information in the notes is tested when the related financial statement components are tested, and the workpapers for those components are the source of the information for notes. If note information is extensive, there is some advantage in preparing a separate schedule to summarize the facts and amounts for note disclosure and to cross-reference that information to the workpapers for related financial statement components.

Summary of Accounting Policies. Accounting standards require disclosure of significant accounting policies. The information may be summarized in the first note to the financial statements or be included in notes on particular financial statement components. For example, depreciation methods may be disclosed in a note on property or included in one note that contains all significant accounting policies. Some auditors find it convenient to summarize a client's significant accounting policies in a carryforward schedule in the workpapers and update that schedule each year.

Disclosure Checklists. The summary of significant accounting policies is only one of many disclosures required by current accounting standards. Even the most experienced auditors find it necessary to use some aid to remind them of the multitude of required disclosures. It is recommended that an audit firm adopt a disclosure checklist and use it in all audit engagements as an overall review for financial statement disclosures.

Drafting the Auditor's Report

Authoritative Literature. AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, provides guidance for forming an opinion and reporting on financial statements. This course provides limited guidance on reporting. However, a companion publication to this *Guide—PPC's Guide to Auditor's Reports*—includes a detailed discussion of authoritative guidance, practical solutions to reporting problems, and illustrations of nearly 300 different types of auditor's reports.

Proposed Statements on Auditing Standards.

On November 28, 2017, the AICPA issued an exposure draft of four proposed statements on auditing standards—

- *Forming an Opinion and Reporting on Financial Statements,*
- *Communicating Key Audit Matters in the Independent Auditor's Report,*
- *Modifications to the Opinion in the Independent Auditor's Report,* and
- *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report.*

The proposed standards would supersede AU-C 700, AU-C 705, and AU-C 706; add AU-C 701; and amend a number of other AU-C sections. Key provisions of the proposals include formatting changes, such as presenting the opinion and basis for opinion sections at the beginning of the report; expanded descriptions of management's responsibilities for the financial statements, the auditor's responsibilities for the audit, and the key features of an audit; and separate sections for when the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern and when financial and nonfinancial information is included in an entity's annual report. The exposure draft also introduces communication of key audit matters (KAMs), but this communication is not required in audits of nonissuers. However, KAMs would be required to be included in the auditor's report *if* the auditor is engaged to report KAMs.

The proposed effective date is for audits of financial statements for periods ending on or after June 15, 2019, with no early adoption. However, due to the pervasiveness of the changes to auditor's reports that the proposals would require, the authors believe it is likely that the effective date could be postponed, perhaps for an additional six months, to periods ending on or after December 15, 2019. The exposure draft is available at **aicpa.org** or in the Advanced and Proposed Documents section of the AICPA Professional Standards on Checkpoint at **www.riagcheckpoint.com**. Future editions of this *course* will update the status of this exposure draft.

Preparing the Draft Auditor's Report. It maybe convenient to prepare the draft auditor's report by revising last year's report. It is particularly important to incorporate changes that might be caused by the following factors:

a. Changes in titles of financial statements; client name, e.g., merger or new form of doing business; or dates, e.g., fiscal year changed for tax purposes.

b. New accounting or auditing pronouncements.

c. Different circumstances requiring modification of the opinion, e.g., adoption of an accounting principle not in conformity with GAAP or new litigation causing a material uncertainty.

Referencing all names, titles, amounts, and representations in the report to supporting documentation in the audit workpapers helps assure an accurate auditor's report. For example, the company's name can be traced to the corporate charter or letterhead, amounts appearing in an emphasis-of-matter or other-matter paragraph can be traced to the trial balance or audited financial statements, and the type of opinion can be traced to a checklist or memo in the workpapers.

Dating the Auditor's Report. GAAS requires that the date of the auditor's report should be no earlier than the date sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, sufficient appropriate audit evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor needs to coordinate the following dates:

- Audit report date.
- Management representation letter date.
- Subsequent events evaluation footnote disclosure date.

In order to coordinate the auditor's report date, management representation letter date, and the subsequent events evaluation footnote disclosure date, the auditor may want to take the following steps:

- Discuss the dating requirements with management in advance of starting the audit.
- Include in the engagement letter a provision that management will not date the subsequent event note earlier than the date of their management representation letter and the date of the auditor's report.

This process will generally result in the date management discloses as the date through which they have evaluated subsequent events being the same date as the auditor's report.

Drafting the Auditor's Report under AU-C 700. AU-C 700 addresses the auditors' responsibility to form an opinion and the form and content of the auditor's report. As discussed in *PPC's Guide to Auditor's Reports* provides extensive guidance and reporting examples. Exhibit 2-3 presents examples of a standard, unmodified auditor's report on comparative financial statements under AU-C 700.

Exhibit 2-3

AUDITOR'S STANDARD REPORT—Comparative GAAP Basis Financial Statements of a Corporation[a, b]

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying financial statements of ABC Company which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor

considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

[Firm's signature]

[Location of Firm (City, State)]

[Report Date]

Notes:

[a] Authority—AU-C 700.

[b] This illustration is provided as an example of a standard report for a corporation with comparative financial statements. *PPC's Guide to Auditor's Reports* provides guidance and numerous reporting examples under GAAS.

* * *

Discussion with Management

After the workpapers, draft financial statements (normally stamped or annotated on each page, such as "Draft—For Discussion Purposes Only"), and draft auditor's report have been reviewed, a meeting is usually held with management to discuss the statements and report. The primary focus in the discussion with management is review of the draft financial statements and auditor's report. Usually, in a small business engagement, the emphasis is on explanation of matters such as:

a. Complex accounting principles and the effect of their application on the financial statements. (The depth of the discussion depends on the knowledge and experience of management.)

b. Relationship of the representations in the management representation letter to the financial statements.

In addition, a closing meeting with the client is an opportunity for effective two-way communication with the client's management. The auditor can increase his or her understanding of the client's business and business risks by making inquiries of management about the future outlook for the company and significant risks or concerns of management. Such communication may be helpful in planning future audits and provide additional support for conclusions reached in the current-year audit. It can also be used to communicate matters as required under AU-C 260, *The Auditor's Communication With Those Charged With Governance.*

Unresolved Issues. If there are any unresolved issues concerning financial statement presentation, they are discussed at this time. The auditor needs to explain the effect on the audit report of departures from GAAP, particularly issues concerning adequacy of disclosure.

Internal Control Related Matters, Errors, and Fraud. The discussion with management needs to also include problems identified in the audit, such as internal control related matters, material errors, and fraud. The auditor will usually also want to make suggestions for improvements to avoid those problems in the future, if that is possible.

Other Matters. A variety of other matters may also be covered in this discussion with management. Some auditors find it useful to discuss one or more of the following in the meeting:

a. *Fees.* It can be effective to discuss the audit fee at this time so that the amount of the fee can be explained in relation to the problems that arose in fieldwork.

b. *Management Comments.* Observations and suggestions about operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client that go beyond internal control related matters and, in the auditor's judgment, are not control deficiencies that should be otherwise communicated under professional standards, can be communicated to the client in a management comment letter or verbally.

c. *Other Services.* The arrangements for the nature and extent of other services, e.g., tax preparation, tax advice, or cash flow projection, can be confirmed.

d. *Report Copies.* Arrangements can be confirmed for the number of copies of the final financial statements and audit report to be supplied.

Consistency of the Financial Statements

As part of the audit and reporting on financial statements, the auditor is required to evaluate the consistency of financial statements between periods.

Objectives and Requirements. The objectives of the auditor under AU-C 708, *Consistency of Financial Statements*, are to (a) evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements, and (b) when that is the case, appropriately modify the audit report.

The AU-C 708 performance requirements regarding consistency of financial statements are listed in Exhibit 2-4. AU-708 also contains other requirements regarding reporting when changes in consistency occur. Those are not discussed in this course, but are discussed in *PPC's Guide to Auditor's Reports*.

Exhibit 2-4

Requirements Related to Consistency

Requirements	AU-C Reference
Evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements.	AU-C 708.05
Evaluate whether the financial statements reported on are consistent with previously issued financial statements for those periods.	AU-C 708.06
When reporting on comparative financial statements, evaluate consistency between the periods presented and consistency of the earliest period presented with the prior period if that prior period also is presented.	AU-C 708.06

Requirements	AU-C Reference
Evaluate a change in accounting principle to determine whether (a) the newly adopted principle and the method of accounting for the change are in accordance with the applicable reporting framework, (b) the disclosures of the accounting change are appropriate and adequate, and (c) the entity has justified that the alternative accounting principle is preferable.	AU-C 708.07
Evaluate consistency of accounting principles of investees in financial statements containing investments accounted for by the equity method.	AU-C 708.12
Evaluate a material change in classification and related disclosure to determine whether the change is also either a change in accounting principle or an adjustment to correct a material misstatement in previously issued financial statements. If so, follow the appropriate guidance in AU-C 708 for changes in accounting principle or adjustments to correct a material misstatement in previously issued financial statements.	AU-C 708.16

* * *

Reporting Matters. AU-C 708.A1 indicates that when the comparability of the financial statements is not materially affected by either changes in accounting principle or restatement of previously issued financial statements, the auditor need not refer to consistency in the auditor's report.

AU-C 708 includes specific reporting requirements when there are material changes that affect consistency in the financial statements. For example, when an entity adopts a new accounting principle and the comparability of the financial statements is materially affected by the change, AU-C 708 requires the auditor to refer to the change in an emphasis-of-matter paragraph of their report. In that case, the auditor should determine that (a) the newly adopted principle is a generally accepted accounting principle, (b) disclosure of the change and the method of accounting for the effect of the change is in accordance with FASB ASC 250 or other applicable pronouncement, and (c) management has justified that the alternative accounting principle is preferable. AU-C 708 also includes other reporting requirements, including requirements relating to changes in accounting principles, changes in accounting estimates affected by changes in accounting principles, error corrections involving accounting principles, changes in the reporting entity, and error corrections not involving accounting principles. *PPC's Guide to Auditor's Reports* includes an in-depth discussion of AU-C 708 and consistency matters affecting the auditor's report.

COMMUNICATING INTERNAL CONTROL RELATED MATTERS

Introduction and Authoritative Literature

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies that they have identified during the audit. Control deficiencies that are, in the auditor's judgment, *significant deficiencies* or *material weaknesses* should be communicated in writing to management and those charged with governance.

Definitions. AU-C 265, as amended by AU-C 940, contains the following definitions:

- *Deficiency in Internal Control.* "A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively."

- *Significant Deficiency.* A significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance."

- *Material Weakness.* A material weakness is "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

  - *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.

  - *Probable.* The future event or events are likely to occur."

Objectives and Requirements

The following paragraphs summarize the objectives and requirements for the communication of internal control matters under AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

The objective of the auditor when communicating internal control related matters is to communicate to management and those charged with governance identified deficiencies in internal control that are, in the auditor's professional judgment, of sufficient importance to merit their attention. The requirements that should be followed to achieve that objective are summarized in Exhibit 2-5.

Exhibit 2-5

Requirements for Communicating Internal Control Related Matters Identified in an Audit

Requirements	AU-C Reference
Determination of Whether Deficiencies in Internal Control Have Been Identified	
The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.	AU-C 265.08
Evaluating Identified Deficiencies in Internal Control	
If the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses.	AU-C 265.09
If the auditor initially determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.	AU-C 265.10
Communication of Deficiencies in Internal Control	
The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit.	AU-C 265.11
The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis: • In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances. • In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.	AU-C 265.12

Requirements	AU-C Reference
The communications should be made no later than 60 days following the report release date.	AU-C 265.13
The auditor should include in the written communication of significant deficiencies and material weaknesses: • The definition of the term *material weakness* and, when relevant, the definition of the term *significant deficiency*. • A description of the significant deficiencies and material weaknesses and an explanation of their potential effects. • Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following elements that explain that: •• The purpose of the audit was for the auditor to express an opinion on the financial statements. •• The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control. •• The auditor is not expressing an opinion on the effectiveness of internal control. •• The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.	AU-C 265.14
• In accordance with AU-C 905, *Alert That Restricts the Use of the Auditor's Written Communication*, a restriction regarding the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report.	
When the auditor issues a written communication stating that no material weaknesses were identified during the audit, the communication should include the matters in AU-C 265.14a and c–d.	AU-C 265.15
The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.	AU-C 265.16
For audits of group financial statements, the group engagement team should communicate to group management and those charged with governance material weaknesses and significant deficiencies in internal control that are relevant to the group (either identified by the group engagement team or brought to its attention by a component auditor during the audit).	AU-C 600.46

* * *

Identifying Control Deficiencies

AU-C 265.08 states that the auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.

An auditor may become aware of control deficiencies while performing a variety of audit procedures, including obtaining an understanding of the entity's internal control, performing risk assessment procedures, or performing tests of the operating effectiveness of controls (that is, tests of controls). For example, a test of controls may detect deviations from prescribed procedures. Deviations might be caused by factors such as changes in personnel, human error, or significant fluctuations in the volume of transactions. The auditor does not draw an immediate conclusion about the operating effectiveness of a control (and, thus, the existence of an identified deficiency) when a deviation is detected. Instead, the auditor determines whether the entity has another strong control, or a combination of effectively operating controls, that achieve the same control objective as the weak or ineffectively operating control that gave rise to the deviation. In that case, the auditor might conclude that there is no identified deficiency.

Therefore, before concluding on the existence of an identified deficiency, the auditor needs to understand the cause of the deviation and its potential effect on the financial statements by making specific inquiries of management. Ordinarily, the auditor discusses the relevant facts and circumstances related to the potential deficiency with the appropriate level of management. In most cases, that includes management personnel who are familiar with the internal control area affected and who have the authority to take remedial actions. In certain circumstances, however, it might not be appropriate for the auditor to discuss the findings directly with management. For example, certain findings might cause the auditor to believe that (a) there is evidence of fraud or intentional noncompliance with laws and regulations by management or (b) management is unable to oversee the preparation of adequate financial statements, which may raise doubts about management's competence. In those circumstances, it generally would not be appropriate for the auditor to communicate such deficiencies directly to management.

When discussing the facts and circumstances surrounding the auditor's findings with management, the auditor may obtain information that is relevant to his determination, including:

- The actual or suspected cause of the deficiency.
- Exceptions or deviations arising from the deficiency (for example, a misstatement that was not prevented by the relevant IT controls).
- A preliminary indication of management's response to the auditor's findings.

This information also may prove helpful to the auditor when evaluating the severity of identified deficiencies and communicating relevant information about identified control deficiencies to management and those charged with governance. Finally, such a discussion provides the auditor with an opportunity to alert management, on a timely basis, to the existence of previously unknown deficiencies.

Examples of Deficiencies. A control deficiency may be either a deficiency in design or a deficiency in operation. A *deficiency in design* exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A *deficiency in operation* exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Exhibit 2-6 lists examples from AU-C 265.A37 for both deficiencies in design and deficiencies in operation. While AU-C 265 distinguishes between the two types of control deficiencies, there is no requirement to indicate in the communication to management and those charged with governance which are deficiencies in design and which are deficiencies in operation.

Exhibit 2-6

Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses

Deficiencies in the Design of Controls

- Inadequate design of internal controls over the preparation of financial statements.
- Inadequate design of a control over a significant account or process.
- Inadequate documentation of the internal control components.
- Insufficient control consciousness within the organization, e.g., the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (if those controls would be necessary for effective internal control over financial reporting).

- Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.

- Employees or management lack the qualifications and training to fulfill their assigned functions (for example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements).

- Inadequate design of monitoring controls used to assess the design and operating effectiveness of internal control over time.

- The absence of an internal process to report internal control deficiencies to management on a timely basis.

- An indication that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance or other evidence that certain aspects of the control environment are ineffective.

- Failure of management to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified or other evidence that the entity's risk assessment process is ineffective.

- Absence of controls over a significant identified risk or other evidence of an ineffective response to significant risks that have been identified.

- Absence of a risk assessment process when such a process would ordinarily be expected to have been established.

Failures in the Operation of Controls

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control requiring dual authorization for significant disbursements).

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations).

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration when it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs timely periodic physical inventory counts (detective control). Although a physical inventory count does not safeguard inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, because the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (in this case, the physical inventory) prevents a misstatement of the financial statements. A material weakness relating to controls over the safeguarding of assets would exist only if the entity does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct, a material misstatement of the financial statements.[a]

- Failure to reconcile significant accounts (for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner).

- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, expenses are consistently understated at the direction of management.

- Misrepresentation by the client to the auditor (an indicator of fraud).

- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

Note:

[a] Even if the auditor determines that the failure of safeguarding and other controls is not a significant deficiency or material weakness, best practices indicate that the matter will normally be communicated at a minimum as a control deficiency because of the importance many clients place on the prevention of theft. It is important to have a clear understanding with the client about the auditor's responsibility for communicating immaterial fraud.

* * *

Evaluating Identified Deficiencies

If the auditor has identified one or more deficiencies in internal control, AU-C 265.09 states that the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses. Auditors should evaluate control deficiencies individually and in combination with other deficiencies affecting the same significant class(es) of transactions, significant account balance(s) or disclosure(s), relevant assertion, or component of internal control. This is because multiple control deficiencies that affect the same financial statement class(es) of transactions, account balance(s) or disclosure(s) , relevant assertion or component of internal control increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

If the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, AU-C 265.10 states that the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

Indicators of Material Weaknesses. AU-C 265 states that the following are indicators of a material weakness:

- Identification of fraud, whether or not material, on the part of senior management.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
- Identification by the auditor of a material misstatement of the financial statements in circumstances indicating that the misstatement would not have been detected by the entity's internal control.
- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

While AU-C 265 identifies the factors described in the preceding paragraph only as *indicators of material weaknesses*, best practices indicate that auditors generally would consider such deficiencies material weaknesses. For that reason, many auditors begin the evaluation process by determining whether any of the deficiencies identified during the audit are indicators of a material weakness.

AU-C 265.A5 provides guidance on evaluating the severity of an identified deficiency, stating that it depends on:

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies and
- Whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure.

Factors Affecting the Magnitude of a Potential Misstatement. While AU-C 265 discusses evaluating the magnitude of a potential misstatement, it is really dealing with whether an identified deficiency could result in a misstatement that is material to the financial statements. Determining what is material to the financial statements is one of the most difficult parts of applying AU-C 265.

If a factual misstatement has occurred, it obviously is easier for the auditor to evaluate the severity of an identified control deficiency since the amount of the misstatement is known. In that instance, however, it is still necessary to evaluate whether the control deficiency could result in additional misstatements. In many cases, though, the auditor will be evaluating only a potential misstatement. According to AU-C 265.A6, factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in internal control, include, but are not limited to, the following:

- The financial statement amounts or transaction totals exposed to the deficiency.
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency.

Generally, the most an account balance or transaction total could be overstated is the recorded amount. Potential understatement, however, is not limited to the recorded amount. For instance, if there is a control deficiency related to segregation of duties over accounts receivable, and the recorded amount is $250,000, that is the most accounts receivable could be overstated. However, accounts receivable potentially could be understated by any amount because an unlimited amount of receivables could have been misappropriated due to the segregation of duties deficiency.

Other than the indicators of material misstatements, AU-C 265 does not provide any additional insight for determining the magnitude of a potential misstatement. However, Statement of Financial Accounting Concepts (SFAC) No. 8, *Conceptual Framework for Financial Reporting—Chapter 1, "The Objective of General Purpose Financial Reporting," and Chapter 3, "Qualitative Characteristics of Useful Financial Information,"* recognizes that *qualitative*, as well as *quantitative* factors, can influence an auditor's materiality judgments.

AU-C 320, *Materiality in Planning and Performing an Audit*, elaborates on that guidance in AU-C 320.A12, which provides the following examples of circumstances that might cause a misstatement to be material, even when the amount falls below the quantitative materiality threshold:

- Whether laws or regulations affect users' expectations about how certain information should be measured or disclosed (for example, related party transactions and the remuneration of management and those charged with governance).
- The key disclosures with regard to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

In addition to those circumstances, best practices indicate that auditors may also consider circumstances such as the following when evaluating the magnitude of a potential misstatement permitted by an identified control deficiency, including whether the deficiency:

- While quantitatively small in relation to the entity's net income for the current period, is significant to the overall trend of earnings (for example, a misstatement that reverses a downward trend of earnings or changes a loss into income).

- Results in events or circumstances that could materially affect the financial statements. For example, an illegal payment of an otherwise immaterial amount might be material if it could lead to a material contingent liability or a material loss of revenue. In addition, some misstatements, although not individually significant, may be pervasive to the financial statements (that is, misstatements that affect numerous financial statement amounts, subtotals, or totals).

- Masks a change in earnings or other trends, especially in the context of general economic conditions.

- Affects the entity's compliance with loan covenants, other contractual agreements, or regulatory provisions (for example, a misstatement that would reveal a default under a debt covenant).

- Affects an entity's investment in a joint venture, when the joint venture partners are users of the financial statements under audit.

- Would be the result of fraud or suspected fraud. (In this case, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, as described in AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, even if the effect of the misstatement is not material to the financial statements.)

- Affects professional fees, if the auditor is concerned that there is an inadequate understanding of the client's litigation exposure and the identity of all attorneys engaged during the period.

- Affects material disclosures related to a small account balance. (For example, a joint venture investment might be small at the balance-sheet date, but a subsequent events note might indicate a subsequent major investment in that joint venture project that holds the key to the client's future success.)

In summary, the auditor needs to draw on the knowledge and understanding of the client to identify all of the qualitative factors that might influence the auditor's judgment about the magnitude of a potential misstatement and, thus, judgments about the severity of an identified control deficiency. Finally, it is important for the auditor to recognize that qualitative considerations are used only to determine whether the auditor's final judgment about the severity of an identified control deficiency is greater than, but never lower than, the auditor's preliminary judgment about the quantitative effect.

Finally, auditors are encouraged to remember that the magnitude of a potential misstatement discussed in AU-C 265 affects only whether a deficiency is communicated to management and those charged with governance. Unlike judgments about materiality, which can affect whether a client's financial statements are fairly presented (and, thus, the auditor's opinion on those statements), the auditor's judgment about the magnitude of a potential misstatement affects only whether the auditor is required to communicate the identified deficiency to the client. Therefore, when in doubt about the severity of a control deficiency, best practices suggest that the auditor communicate it to the client.

Factors Affecting Whether There is a Reasonable Possibility of a Misstatement. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable. AU-C 265.A8 lists a number of risk factors that may affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in internal control will result in a misstatement of an account balance or disclosure. Those factors include, but are not limited to, the following:

- The nature of the classes of transactions, account balances, disclosures, and assertions involved (for example, suspense accounts or transactions with related parties may present more risk).

- The cause and frequency of exceptions detected as a result of the deficiency(ies).

- Susceptibility of the related assets or liabilities to loss or fraud.

- The complexity, subjectivity, or extent of judgment needed to determine the amount involved.

- The relationship and interaction of the control with other controls.

- Interaction of the control deficiency with other control deficiencies.
- Possible future consequences resulting from the deficiency.
- The importance of controls to the financial reporting process—for example, general monitoring controls (such as oversight of management) or controls over:
  - The prevention and detection of fraud
  - The selection and application of significant accounting policies
  - Significant transactions with related parties
  - Significant transactions outside the entity's normal course of business
  - The period-end financial reporting process (such as controls over nonrecurring journal entries)

PPC's Process for Evaluating the Severity of Deficiencies. In summary, when evaluating the severity of an identified control deficiency under AU-C 265, best practices indicate most auditors will begin by considering whether an identified deficiency is considered a material weakness. If not, they will consider its severity to determine whether to communicate it to management and others as a significant deficiency. Specifically, best practices indicate that the process will be as follows:

- For an identified deficiency, determine whether it is a material weakness by considering whether (a) the magnitude of the potential misstatement could result in a material misstatement to the financial statements and (b) there is a reasonable possibility that the misstatement would not be prevented, or detected and corrected, on a timely basis by the entity's internal controls.
- For an identified deficiency not considered a material weakness, consider whether the deficiency is important enough to merit attention by management and those charged with governance as a significant deficiency. When making this evaluation, consider whether a prudent official with knowledge of the same facts and circumstances would likely reach the same conclusion.
- Combine individual deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control and evaluate whether they are considered either a significant deficiency or a material weakness.

Finally, for other deficiencies in internal control not communicated as either material weaknesses or significant deficiencies, the auditor should consider whether to communicate them to management in accordance with the requirement in AU-C 265.12(b).

Combination of Identified Deficiencies

As previously discussed, in addition to evaluating the severity of individual control deficiencies identified during the audit, AU-C 265.09 states that the auditor should evaluate whether deficiencies are considered to be material weaknesses or significant deficiencies when combined with other deficiencies affecting the same class of transactions, account balance or disclosure, relevant assertion, or component of internal control.

To illustrate, assume an auditor considers several control deficiencies in and of themselves insignificant and, thus, only control deficiencies. If those control deficiencies were related, however (for example, they all related to the same account balance), the requirement in AU-C 265 to combine control deficiencies might cause the auditor to consider them a significant deficiency or material weakness. Exhibit 2-7 provides examples of how an auditor might combine multiple deficiencies identified during the audit to evaluate whether they rise to the level of a material weakness or a significant deficiency.

Exhibit 2-7

Examples of Combination of Multiple Deficiencies That Combine to a Material Weakness

The auditor has identified the following control deficiencies and concluded that, individually, each of the deficiencies is a significant deficiency:

- Several accounts receivable transactions were not properly recorded in the subsidiary ledger (the transactions were not material, either individually or in the aggregate).
- Account balances affected by the improperly recorded accounts receivable transactions were not reconciled on a timely basis.
- The company has inadequate segregation of duties over IT access controls related to the accounts receivable and billing function.

Because each of the significant deficiencies affects the same account (accounts receivable), the deficiencies, when considered together, represent a reasonable possibility that a material misstatement could occur and not be prevented or detected or corrected. Thus, the auditor likely would conclude that, in combination, the significant deficiencies represent a material weakness.

In another example, assume an auditor identified several control deficiencies that relate to a specific component of internal control instead of to a specific account balance or disclosure. Three control deficiencies relate to the entity's lack of adequate reviews and approvals. While each of these control deficiencies relate to different account balances, they all relate to the monitoring component of internal control. Thus, even though the auditor determined that individually each deficiency was only a control deficiency, the requirement in AU-C 265 to combine control deficiencies by internal control component might cause the auditor to consider them a significant deficiency or even a material weakness.

* * *

Prudent Official Test

AU-C 265 requires auditors to consider whether a prudent official with knowledge of the same facts and circumstances would likely reach the same conclusion. In other words, would a prudent official, with knowledge of the facts and circumstances, other controls tested, and the likelihood and magnitude of potential misstatement, agree with the auditor's conclusion that the deficiency is not a material weakness? Stated more simply, would a prudent official with knowledge of the same facts and circumstances agree with the auditor's classification of the control deficiency?

From a practical standpoint, best practices indicate that the auditor's consideration of whether a "prudent official" would agree with the auditor's classification of a control deficiency depends, at least to some extent, on the nature of the client's business and the needs of the users of the financial statements. In a regulated environment, evaluating the severity of the deficiency through the eyes of a regulator might be the most practical approach. For instance, an auditor of a financial institution generally evaluates the severity of control deficiencies by considering the views of a more cautious regulator. In some instances, that might lead the auditor to a more conservative classification of a control deficiency than the auditor would make for a client that operates in a nonregulatory environment. However, an auditor of a small manufacturing company, which is not concerned with regulatory issues, might consider instead whether an experienced business person or another practitioner would agree with the auditor's classification of the control deficiency, given the same facts and circumstances. *PPC's Guide to Internal Control Communications* discusses this issue further.

Finally, it is important to understand that the prudent official test is used only to gauge whether the auditor's final judgement about the severity of a control deficiency is greater than, but never lower than, the auditor's preliminary judgment.

Practice Issues

The following paragraphs discuss the following issues:

- If the auditor prepares the financial statements, does the client automatically have a control deficiency?
- What is the relationship between AU-C 265 and the AICPA's independence rules relating to nonattest services?
- Would a client's lack of segregation of duties automatically cause the auditor to communicate a material weakness?
- If an auditor identifies a material misstatement during the course of the audit, does the auditor always have to communicate a material weakness to the client?
- Should a control deficiency that allows fraud to occur always be considered a material weakness?

Do Clients Automatically Have a Deficiency if The Auditors Prepare the Financial Statements?

The auditor's preparation of the financial statements does not automatically indicate that there is a material weakness, significant deficiency, or other control deficiency. Many smaller nonpublic clients request auditors to prepare, or assist with preparing, the financial statements and related disclosures. Those services can range from preparing the complete set of financial statements (including the notes) to preparing only one statement (such as the statement of cash flows), to preparing only the notes to the financial statements.

The auditor's preparation of financial statements does not cause a control deficiency; however, it may be the result of a control deficiency. When determining whether a control deficiency exists under AU-C 265, the issue to consider is whether the client has controls in place to prevent, or detect and correct, misstatements in the financial statements.

If auditors prepare financial statements for a client, they should understand and distinguish between their responsibilities to determine whether (a) there is a material weakness or significant deficiency that should be communicated to the client under AU-C 265 and (b) they are independent under the AICPA's independence requirements (the preparation of financial statements is a *nonattest* service). That means that, before auditors prepare financial statements for their clients, they should determine that the requirements of ET Section 1.295 have been met.

The auditor's preparation of the financial statements and the related notes also does not relieve the client of the responsibility for the statements and for the establishment of controls over the financial reporting process. A white paper, entitled *Preparation as a Nonattest Service: What Does it Mean and Why Should I Care?*, by Charles E. Landes, CPA, reinforces that the financial statements are management's responsibility and that management needs to be responsible for their preparation. The white paper also goes on to say, "[t]hat doesn't mean (management) can't *outsource* the preparation, but it does mean that they can't outsource their responsibility." That position is supported by a change to ET Section 1.295 which deleted a prohibition against a member "designing or maintaining internal controls" for the client. The deletion of that prohibition enables auditors to design or maintain controls over financial statement preparation and retain their independence as long as management agrees to (a) accept responsibility for such controls and (b) performs all the requirements of ET Section 1.295 for nonattest services. Determining whether a control deficiency exists and whether it is a significant deficiency or a material weakness may be a difficult judgment call. Auditors need to evaluate the facts and circumstances specific to each situation.

The requirements of ET 1.295 include obtaining management's agreement to oversee the financial statement preparation service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience. Under ET Section 1.295, the individual designated by management should possess the technical skills, knowledge, and experience sufficient to (a) understand the financial statement preparation service enough to be able to provide general direction for the service; (b) understand the key issues the auditor identifies; (c) make any required management decisions; and (d) evaluate the adequacy of, and accept responsibility for, the results of the auditor's work. The auditor considers whether the designated individual fulfills this competency requirement based on factors such as the individual's understanding of the service, knowledge of the client's business and industry, general business knowledge and education, and position within the client. When assessing competency, the relative importance of those factors is considered in relation to the financial statement preparation service being performed.

Before the auditor concludes he or she can prepare financial statements for an audit client because he or she can meet the independence requirements described in the preceding paragraphs, the auditor also should consider the cumulative effect of performing multiple nonattest services on the threats to independence.

Lack of Segregation of Duties. Because of their limited resources, smaller businesses are generally more sensitive to the costs of implementing effective controls. Often, the quality of evidence and other documentation that is necessary to denote the existence and operation of key controls can place additional burdens on smaller entities because of a lack of segregation of duties and lower levels of accounting sophistication frequently present in such organizations. Despite these challenges, the COSO Framework states that internal control components and related principles for achieving effective internal control over financial reporting are the same for smaller entities as for their larger counterparts. No exemption or special relief is given to a smaller entity because of its size or the challenges of achieving effective internal control. However, the approaches that a smaller entity may adopt in implementing the components and satisfying underlying principles will generally differ from those of a larger entity.

As noted in Exhibit 2-6, absent or inadequate segregation of duties within a significant account or process is an example of a deficiency in the design of controls according to AU-C 265. As such, an auditor should evaluate the severity of the deficiency by considering the probability of occurrence of a misstatement and the magnitude of the potential misstatement in accordance with the standard.

In an example from a previously issued risk alert, the client's accounting department consists of a lone bookkeeper. Because the bookkeeper has been with the company for many years, the owner frequently leaves blank, signed checks with the bookkeeper to be used "in case of emergency." The owner does not perform any oversight functions; she believes the auditors are a substitute for her lack of oversight. Therefore, she has the auditors perform quarterly interim procedures, including a review of the bank reconciliation prepared by the bookkeeper. Because there is inadequate segregation of duties in the accounting department, there is a deficiency in the client's internal controls. Since there is at least a reasonable possibility that the bookkeeper could use one of the blank checks to make an unauthorized withdrawal of company funds, and that withdrawal could be material, the auditor concludes that the deficiency is a material weakness. (That example assumes there are no compensating controls for the auditor to consider since the owner performs no oversight procedures.)

Auditor Identifies a Material Misstatement. During the course of an audit, an auditor might identify (and propose adjustments to correct) any number of errors, some of which may be material to the entity's financial statements. AU-C 265 states that the auditor's identification of a material misstatement of the financial statements in circumstances that indicate that it would not have been identified by the entity's internal control is a strong indicator of a material weakness. Therefore, whenever the auditor identifies a material misstatement in the financial statements, he or she needs to evaluate whether the control deficiency that allowed the misstatement to occur represents a material weakness. Exhibit 2-8 illustrates a situation in which the auditor's evaluation of the severity of a control deficiency that allowed a material misstatement in the client's financial statements resulted in its classification as a material weakness.

Exhibit 2-8

Auditor Identifies Material Misstatements

The client experienced significant turnover of personnel during the year. At year end (and for much of the year), there was no one on staff with the expertise to analyze complex transactions to ensure that all transactions were properly recorded in the financial statements in accordance with GAAP. As a result, the financial statements contained numerous errors and the auditor proposed several adjustments subsequent to the start of the audit. Material adjustments included the recording of prior year audit adjustments and writing off uncollectible receivables. Several other adjustments were made to correct immaterial errors.

Because the client lacked controls to prevent, or detect and correct, material misstatements in the company's financial statements, the auditor concluded this deficiency would be considered a material weakness.

* * *

If an auditor identifies a misstatement that is less than material, best practices indicate that the auditor also should evaluate whether the control deficiency that allowed the misstatement to occur represents a control deficiency, a significant deficiency, or a material weakness. If the auditor determines the control deficiency is, individually or when combined with other deficiencies, a significant deficiency or a material weakness, AU-C 265 requires the auditor to communicate such deficiencies to the appropriate parties.

Occurrence of Fraud. When an auditor becomes aware of fraud that has occurred, the auditor is responsible for evaluating the severity of the control deficiency (ies) that allowed it to occur. Some auditors have questioned whether a control deficiency that allows fraud to occur should always be considered a material weakness. An example from a previously issued risk alert assumed that deficiencies in a client's controls over its parts inventory allowed the parts manager to sell parts and pocket the money without recording the related sales. However, a discrepancy noted during the most recent physical inventory led management to discover the fraud. Although the actual amount to writedown the inventory account for the fraud was not material, AU-C 265 requires the auditor to evaluate the potential for further material misstatements when considering the severity of the control deficiency.

From the example, it is clear that the client's physical inventory detected the misstatement that resulted from the fraud. Accordingly, the auditor believed there was less than a reasonable possibility that a misstatement, whether material or immaterial, of the client's financial statements would occur. Therefore, the auditor concluded that the deficiency should not be considered a material weakness. However, while the fraud did not cause the client's financial statements to be materially misstated, the fraud is evidence of a deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition. For that reason, best practices indicate an auditor generally would consider the control deficiency a significant deficiency. In any event, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to bring fraud to the attention of an appropriate level of management; from a practical standpoint, most auditors would include a discussion of the control deficiency in the internal control communication.

Communication of Identified Deficiencies

Required Communications. AU-C 265.11 states that the auditor should communicate significant deficiencies and material weaknesses identified during the audit in writing to *those charged with governance*.

In addition, AU-C 265.12 states that the auditor also should communicate the following *to management*:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

- In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of

sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

Making such communications in writing reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities. AU-C 260, *The Auditor's Communication With Those Charged With Governance* (AU-C 260.09), establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.

Significant Deficiencies and Material Weaknesses Remediated during the Audit. AU-C 265.11 states the auditor should communicate in writing significant deficiencies and material weaknesses identified and remediated during the audit. Assume, for instance, that an auditor identified certain significant control deficiencies while performing audit procedures at an interim date. Because of the nature of the items identified, the auditor orally communicated them to management at the end of the interim procedures, and management remediated the deficiencies before year end. Would the auditor have to include such deficiencies in his or her written communication at year end? Yes, AU-C 265.A17 clarifies that the auditor is still required to include such significant deficiencies in the written communication at year end. That is because of the need to inform users about the possibility that a misstatement may have occurred while the significant deficiency existed, even though it has been corrected by year end. Of course, if management is preparing a written response to the auditor's communication, they may wish to include in the auditor's communication a statement that the significant deficiency has been remediated by year end.

Significant Deficiencies and Material Weaknesses Previously Communicated (But Not Remediated). Although management and those charged with governance already may be aware of significant deficiencies and material weaknesses that the auditor has identified, they may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirements to communicate significant deficiencies and material weaknesses in AU-C 265 apply, regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies. Furthermore, the fact that the auditor communicated a significant deficiency or material weakness to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication in the current year if remedial action has not been taken yet. AU-C 265.A20 states that the auditor may ask management or, when appropriate, those charged with governance, why the significant deficiency or material weakness has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency or material weakness.

If a previously communicated significant deficiency or material weakness remains, one option is for the auditor to repeat in the current year's written communication the description from the previous communication. In this case, best practices indicate that there should be an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as "Significant Deficiencies Communicated in Prior Years." Prior-year comments typically are presented after new comments. Another option is for the current year's written communication to merely refer to the previously-issued communication and its date.

Contents of the Communication

AU-C 265.12 states the auditor should provide a written communication of the significant deficiencies and material weaknesses identified during the audit, and the communication should include the following items:

a. The definition of a material weakness and, when relevant, of a significant deficiency.

b. A description of each significant deficiency and material weakness identified along with an explanation of their potential effects.

c. Sufficient information to allow those charged with governance and management to understand the context of the communication. In particular, the auditor's communication should include elements to explain that:

   (1) The purpose of the audit was for the auditor to express an opinion on the financial statements.

   (2) The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.

   (3) The auditor is not expressing an opinion on the effectiveness of internal control.

   (4) The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

d. A paragraph restricting the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report, in accordance with AU-C 905, *Restricting the Use of the Auditor's Written Communication*.

When explaining the potential effects of the significant deficiencies and material weaknesses, it is not necessary for the auditor to quantify those effects. In fact, the potential effects may be described in terms of (a) the control objectives that might not be achieved; (b) the types of errors the control was designed to prevent, or detect and correct; or (c) the risk(s) of misstatement that the control was designed to address. In some cases, the potential effects may be evident from the description of the significant deficiencies or material weaknesses, and therefore no further explanation would be necessary.

When preparing the written communication, the auditor may decide to group significant deficiencies or material weaknesses together. The auditor also may include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement about whether the auditor has undertaken any steps to verify whether management's responses have been implemented. The auditor also may decide to include in the communication the following information as additional context:

- The general inherent limitations of internal control, including the possibility of management override of controls.
- The specific nature and extent of the auditor's consideration of internal control during the audit.

Level of Detail Included in Written Communication. The auditor should use professional judgment when determining the level of detail at which to communicate significant deficiencies and material weaknesses. When making that determination, AU-C 265.A18 states that the auditor may consider the following factors:

a. *The Nature of the Entity.* For example, the level of detail in a communication for a governmental entity may differ from that required for a communication to a nongovernmental entity.

b. *The Size and Complexity of the Entity.* For example, the level of detail in a communication required for a complex entity may differ from that required for an entity that operates a simple business.

c. *The nature of significant deficiencies and material weaknesses the auditor has identified.*

d. *The Entity's Governance Composition.* For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.

e. *Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.*

Timing of the Communications

AU-C 265.13 states that the auditor should make the required communications no later than 60 days following the report release date. (The *report release date* is defined in AU-C 230, *Audit Documentation*, as the date the auditor

grants the entity permission to use the auditor's report in connection with the financial statements. In many cases, the report release date will be the date the auditor delivers the report to the client.) Despite the requirement to make these communications no later than 60 days following the report release date, AU-C 265.A16 states that the communication is best made by the report release date because early communication of identified deficiencies may be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Nevertheless, because the auditor's written communication of significant deficiencies and material weaknesses forms part of the final audit file, the written communication is subject to the overriding requirement in AU-C 260.16 for the auditor to complete the assembly of the final audit file on a timely basis, no later than 60 days following the report release date.

AU-C 265.A17 clarifies that early communication of significant deficiencies and material weaknesses to those charged with governance or management is important for some matters because of their relative significance and the urgency for corrective follow-up action. Regardless of the timing of the written communication, the auditor may first communicate these matters orally to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. However, communicating the matters orally does not relieve the auditor of the responsibility to communicate the significant deficiencies and material weaknesses in writing as required by AU-C 265.

Reporting When There Are No Significant Deficiencies

AU-C 265.16 precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because the potential for such a communication to be misunderstood or misused.

If there are no significant deficiencies, less serious control deficiencies may still exist. AU-C 265.12(b) states that the auditor should communicate, in writing or orally, other deficiencies in internal control that (a) have not been communicated to management by other parties, and (b) in the auditor's professional judgement, are of sufficient importance to merit management's attention.

Reporting When There Are No Material Weaknesses

Those charged with governance or management may request the auditor to provide a written communication indicating they identified no material weaknesses during the audit. Such a written communication does not provide any assurance about the effectiveness of an entity's internal control over financial reporting; however, AU-C 265 does not preclude the auditor from issuing such a communication. (As previously discussed, however, AU-C 265 does preclude the auditor from issuing a written communication stating that no *significant deficiencies* were identified.)

If the auditor agrees to issue a written communication indicating no material weaknesses were identified during the audit, AU-C 265.15 states that the written communication should include the matters required by AU-C 265.14(a), (c), and (d).

Management's Response

Management may prepare (or be required by a regulator to prepare) a written response to the auditor's written communication. Even if not required to do so, it may be to management's benefit to provide a written response in certain circumstances depending upon the engagement and the users of the financial statements. Management's written response might include, for example, a description of the corrective action taken, a discussion of plans to implement new controls, or simply a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so.

If management's response is included in the same document as the auditor's communication, the auditor may disclaim an opinion on such information by adding a paragraph such as the following as the last paragraph of the auditor's communication:

> ABC Company's written response to the significant deficiencies [*and material weaknesses*] identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Other Internal Control Deficiencies

During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies or material weaknesses but that may be of sufficient importance to merit management's attention. In fact, AU-C 265.12(b) states that the auditor should communicate other deficiencies in internal control identified during the audit that (a) have not been communicated to management by other parties and (b) in the auditor's professional judgment, are of sufficient importance to merit management's attention.

The *other internal control deficiencies* discussed in this section include other, less severe control deficiencies that the auditor wishes to communicate (in other words, those the auditor has concluded constitute only *control deficiencies* and not *material weaknesses* nor *significant deficiencies*.) From a practical standpoint, many auditors already communicate such other deficiencies in a separate section of their significant deficiency and material weakness letters or in a management letter. An auditor also often includes in a management letter other matters, such as those that (a) management has asked the auditor to communicate, and (b) the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency or for improving internal control. When the auditor communicates such deficiencies in internal control, AU-C 265.12 clarifies that a written communication is not required. However, if the auditor decides to communicate the information orally, the standard states that the auditor should document the communication in the workpapers.

If the auditor has communicated these matters to management in a prior period, but management has chosen not to remedy them for cost or other reasons, the auditor is not required to repeat the communication in the current period. The auditor also is not required to repeat information about such matters if the information has been previously communicated to management by others such as internal auditors or regulators. However, the auditor may decide to recommunicate these other deficiencies when there has been a change of management or when new information has come to the auditor's attention that alters the auditor's and management's prior understanding regarding the deficiencies. Nevertheless, the auditor should use professional judgment when determining whether management's failure to remedy other deficiencies in internal control that were previously communicated is a significant deficiency requiring communication with those charged with governance.

In some circumstances, those charged with governance may request that the auditor also communicate information about these other deficiencies in internal control to them as well as management. In this situation, the auditor may elect to inform those charged with governance of the nature of the other deficiencies communicated, or may inform them when a communication of other deficiencies has been made to management. In either case, the auditor may use professional judgment to determine whether to communicate this information orally or in writing.

Additional Guidance on Communicating Internal Control Matters

PPC's Guide to Internal Control Communications contains additional guidance on communicating internal control related matters, including hundreds of illustrative comments about significant deficiencies and material weaknesses categorized by significant class(es) of transactions, account balance(s), or disclosure(s) and internal control component(s). The *Guide* can be ordered by calling customer service at (800) 431-9025.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Define significant deficiency.

    a. A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

    b. A deficiency or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

    c. A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

24. Which of the following is a failure in the design of controls?

    a. Duties within a significant process or account are not segregated.

    b. Internal control components that are poorly documented.

    c. Extreme bias by those responsible for accounting decisions.

    d. No process in place to report internal control deficiencies to management on a timely basis.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. Define significant deficiency. **(Page 414)**

    a. A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. [This answer is incorrect. This is the definition of a deficiency in internal control.]

    b. A deficiency or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance. [This answer is correct. AU-C 265, as amended by AU-C 940 defines a significant deficiency as a deficiency or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.]

    c. A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. [This answer is incorrect. This is the definition of a material weakness.]

24. Which of the following is a failure in the design of controls? **(Page 417)**

    a. Duties within a significant process or account are not segregated. [This answer is incorrect. Absent or inadequate segregation of duties within a significant account or process is deficiencies in the design of controls, not a failure in the designs of controls.]

    b. Internal control components that are poorly documented. [This answer is incorrect. Inadequate documentation of the internal control components is a deficiency in the design of controls.]

    c. Extreme bias by those responsible for accounting decisions. [This answer is correct. Undue bias or lack of objectivity by those responsible for accounting decisions is considered a failure in the design of controls. An example of this would be expenses that are consistently understated at management's direction.]

    d. No process in place to report internal control deficiencies to management on a timely basis. [This answer is incorrect. The absence of an internal process to report internal control deficiencies to management on a timely basis is a deficiency in the design of controls.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 3—Concluding the Audit (ASBTG183)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.tr.com**/**ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $95 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($95 for email or fax; $105 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     ASBTG183 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($95 for answer sheets sent by email or fax; $105 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $271 (a 5% discount on all three courses). If you complete four courses, the price for

grading all four is $342 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $404 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **March 31, 2019**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 3—Concluding the Audit (ASBTG183)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Lewis is auditing the financial statements of Neuman Industries and needs to know how to communicate certain matters to those charged with governance. Which of the following authoritative pronouncements would provide Lewis guidance in this situation?

   a. AU-C 220.

   b. AU-C 230.

   c. AU-C 250.

   d. AU-C 260.

2. What is an auditor's initial objective when performing audit procedures related to commitments and contingencies?

   a. Asking management about the possibility of unrecorded commitments or contingencies.

   b. Determine if all significant commitments and contingencies have been identified.

   c. Examining legal expenses and invoices and correspondence from attorneys.

   d. Examining loan agreements, leases, contracts, and similar documents.

3. Which of the following is correct regarding the materiality level specified in the inquiry of legal counsel?

   a. A specified materiality limit is required.

   b. It is generally a fraction of performance materiality.

   c. It is preferable for the lawyer to choose the materiality level.

   d. Do not select this answer choice.

4. During her audit of Georgia's Crafts, Selina decides to disclose a loss contingency. This decision is based on the likelihood of which of the following?

   a. Specified materiality limit.

   b. Lawyer's assessment.

   c. Knowledge of the client.

   d. Unfavorable outcome.

5. It is the auditor's responsibility to determine whether the wording of the lawyer's assessment of the probability of an unfavorable outcome is clear regarding a probable or remote outcome. Which of the following is an example of a lawyer's response that clearly indicates that an unfavorable outcome is remote?

   a. "We believe that the plaintiff's case against the company is without merit."

   b. "We believe the action can be settled for less than the damages claimed."

   c. "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation."

   d. "In our opinion, the company has a substantial chance of prevailing in this action."

6. The letter from the client's lawyer needs to be coordinated with the date of the auditor's report. It is preferred that the letter to be dated cover a period that closely corresponds to the auditor's report date which *generally* is within how many weeks of the report date?

   a. One.

   b. Two.

   c. Three.

   d. Four.

7. Which of the following is allowed based on the determination of materiality in a small business audit?

   a. Restricting representations about the completeness of available financial records.

   b. Limiting management's accountability for fair presentation.

   c. Including a clear discussion of materiality in the representation letter.

   d. Limiting management's acceptance of its responsibility for the implementation of internal control to prevent fraud.

8. What date do reporting entities usually disclose subsequent events through?

   a. The date the financial statements are available to be issued.

   b. The date on which fieldwork is completed.

   c. The date listed on the financial statements.

   d. The auditor's report date.

9. Lauren is completing a subsequent events review of Keating's Quilt Shop. During this review, Lauren investigates certain developments regarding commitments. This is an example of which of the following subsequent events review procedures?

   a. Reading internal financial reports.

   b. Obtaining a management representation letter.

   c. Understanding management's procedures.

   d. Inquiring of management and those charged with governance.

10. Paul is conducting an audit of Landslide Construction Co. Paul is currently reviewing the cash disbursements for related party transactions. Which of the following audit procedures would Paul conduct?

    a. Vouching.

    b. Confirmation.

    c. Inspection.

    d. Recomputation.

11. During Nate's audit of Delaney Publishing Co., he identifies arrangements that indicate the existence of a related party transaction that previously was undisclosed. According to AU-C 550.22, Nate should do all of the following **except:**

    a. Quickly communicate the information to other engagement team members.

    b. Discuss with lawyers their knowledge of the identity of principal parties related to the material transaction.

    c. Ask management to identify all transactions with newly identified related parties.

    d. Question why controls failed to result in disclosure or identification.

12. After Joe reviews management's plans, he decides there is still substantial doubt regarding Presto Coffee Company's ability to continue as a going concern due to repeated operating losses. According to AU-C 570.A7, this is an example of which of the following?

    a. Negative trends.

    b. Other indications of possible financial difficulties.

    c. Internal matters.

    d. External matters that have occurred.

13. An entity should determine the magnitude and likelihood of the potential effects of events and conditions that can raise substantial doubt about an entity's ability to continue as a going concern, along with the consideration of the timing. Which of the following would be an example of an internal matter?

    a. Negative key financial ratios.

    b. Significant overhaul of operations.

    c. Debt restructuring.

    d. Loss of a key franchise.

14. Which of the following is an example of a procedure that would be used to obtain sufficient appropriate audit evidence about whether events and conditions identified and considered in the aggregate create substantial doubt about an entity's ability to continue as a going concern for a reasonable amount of time?

    a. Requesting management to perform an evaluation.

    b. Implementing analytical procedures.

    c. Evaluating subsequent events.

    d. Verifying with third parties the details of arrangements to provide financial support.

15. Which of the following is **not** an example of a procedure that might be significant when obtaining sufficient appropriate audit evidence about whether identified events or conditions raise substantial doubt about the entity's ability to continue as a going concern?

    a. Evaluate and discuss any significant forecasts with management.

    b. Correct any lack of analysis by management to corroborate its evaluation.

    c. Review minutes of meetings of stockholders.

    d. Assess management's plans to handle open customer orders.

16. Disclosures are required of certain risks and uncertainties that meet specified criteria. Which of the following requires a disclosure in all financial statements?

    a. How estimates are used when generating financial statements.

    b. Significant estimates that meet specified criteria.

    c. The current vulnerability based on certain concentrations that meet specified criteria.

    d. Do not select this answer choice.

17. FASB ASC 275 governs the requirements of risks and uncertainties related to financial statements. Which of the following types of financial statements must follow the conditions of FASB ASC 275?

    a. Nongovernmental financial statements prepared in accordance with GAAP.

    b. Summarized interim financial statements.

    c. Financial statements prepared in a condensed method.

    d. Do not select this answer choice.

18. Financial statements prepared in conformity with a special purpose framework.
    Which risks and uncertainties are **not** excluded from the disclosure requirements of FASB ASC 275?

    a. Sudden catastrophes.

    b. Concentrations of revenue from particular products.

    c. Proposed changes in government regulations.

    d. Proposed changes in a company's internal control.

19. Which of the following is **not** a required disclosure per FASB ASC 275?

    a. Nature of operations.

    b. Use of estimates.

    c. The reliance on management or key personnel of the entity.

    d. Certain significant estimates.

20. Which of the following is correct regarding required disclosures of risks and uncertainties?

    a. Disclosure is not required if the potential uncertainly is mitigated by a risk-reduction technique.

    b. Disclosure is required when there is a remote chance of an estimate changing.

    c. Amounts are required to be included in the disclosure.

    d. Disclosures of concentrations must include percentages.

21. Which of the following is an example of a circumstance when accounting estimates other than fair value accounting estimates may be required?

    a. Equipment held for disposal.

    b. Investment impairment.

    c. Specific liabilities or assets acquired in a business combination.

    d. Specific nonmonetary exchanges.

22. Which of the following criteria would keep a company from having to make disclosures about the concentrations of credit risk and fair value of their financial instruments based on the requirements of FASC 825-10-50-3?

    a. The company is a public company as of the financial statement date.

    b. The total assets of the company are $75 million on the financial statement date.

    c. The company owns instruments that are derivatives during the reporting period.

    d. The company has total assets of $150 million on the financial statement date.

23. Upon the conclusion of the audit of Forever Fitness, Asia has not obtained sufficient appropriate audit evidence in relation to a material financial statement assertion. What should Asia do?

    a. Withdraw from the engagement.

    b. Include an explanatory paragraph in the management representation letter.

    c. Express an unqualified opinion.

    d. Express a qualified opinion.

24. When reviewing workpapers at the end of an engagement, who usually performs the detailed review of the audit work?

    a. Audit senior assigned to the engagement.

    b. Staff accountant that did not perform the work.

    c. Partner assigned to the engagement.

    d. Manager assigned to the engagement.

25. Ashleigh is conducting a detailed review of the current workpaper file. Which of the following steps would she perform when reviewing the supporting schedules?

    a. Tracing back to the ledger agreed amounts from the working trial balance.

    b. Properly considering and cross referencing interrelated financial statement components.

    c. Assuring that any audit findings and issues deemed significant have been addressed and documented.

    d. Documenting in the management representation letter unusual matters found in the audit.

26. Nick, a partner with Thompson and Deckard, is conducting the supervisory review of the financial statements of Freestyle Fitness. What is the main focus of Nick's review?

    a. Final audit report.

    b. Summary and evaluation schedules.

    c. Supporting workpapers.

    d. Sign-offs of the engagement team in the audit program.

27. What is the difference between an error and fraud?

    a. Amount of the misstatement.

    b. Integrity of management

    c. Collaboration.

    d. Intent of the act.

28. There are various factors that must be considered when summarizing and evaluating audit differences. An arithmetic mistake made by the staff accountant of a company would be considered what type of factor?

    a. Nature.

    b. Cause.

    c. Amount.

    d. Effect.

29. One aspect of the summarization and evaluation stage of an engagement is an analysis of the amount of audit time spent on the engagement. Generally, how is the amount of audit time spent recorded?

    a. Daily.

    b. Weekly.

    c. Bi weekly.

    d. Monthly.

30. Which of the following financial statements generally does **not** require any additional audit testing?

    a. Statement of functional expenses.

    b. Income statement.

    c. Statement of cash flows.

    d. Balance sheet.

31. Jolene is concluding the audit of Dolly Enterprises. Jolene's team completed their fieldwork on the audit on Monday. The management of Dolly gave Jolene the management representation letter on Tuesday. On Thursday, Jolene completed the auditor's report. Finally, on Friday, Jolene completed the subsequent events review, which did not require any changes to the auditor's report. What day should Jolene date her report?

    a. Monday.

    b. Tuesday.

    c. Thursday.

    d. Friday.

32. Charles is performing an audit of Lowman's Packing Company. He is trying to determine, based on the audit work that he has performed, if he has identified a deficiency in the internal control system. Which of the clarified standards should Charles refer to when making this determination?

    a. AU-C 265.08.

    b. AU-C 265.10.

    c. AU-C 265.14.

    d. AU-C 265.16.

33. Which of the following is a deficiency in the design of controls?

    a. Management is not qualified to fulfill the responsibilities of the position.

    b. Significant accounts have not been reconciled.

    c. The client misrepresented his/herself to the auditor.

    d. The application control failed as a result of a deficiency in the design of the control.

34. According to AU-C 265, a material weakness could be indicated by which of the following?

    a. The restatement of previously issued financial statements due to a change in accounting principle.

    b. Nonmaterial fraud identified by the senior management of the company.

    c. A material misstatement that is identified by the entity's internal control system.

    d. Effective oversight of the entity's financial reporting and internal control by those charged with governance.

35. Which of the following is correct regarding the magnitude of a potential misstatement?

    a. It determines whether the auditor is required to communicate the identified deficiency to the client.

    b. It can affect whether a client's financial statements are fairly presented.

    c. The most an account balance can be understated is the recorded amount.

    d. Factors that affect the magnitude of a potential misstatement usually result from deficiencies in internal control.

36. An auditor's thought process as to whether a prudent official would agree with the auditor's classification of a control deficiency would be based on which of the following?

    a. Facts and circumstances.

    b. Nature of the client's business.

    c. Severity of the misstatement.

    d. Auditor's professional judgment.

37. According to AU-C 265, which of the following is considered a strong indicator of material weakness in a company's financial statements?

    a. Omitted financial statement disclosures that are required by GAAP.

    b. Inaccurate accounting estimates.

    c. Existence of a material misstatement that was not identified by the entity's internal control.

    d. Incorrect data processing for inclusion in the financial statements.

38. Which of the following statements should be included in the written communication that the auditor provides those charged with governance about significant deficiencies and material weaknesses?

    a. A statement defining the terms *significant deficiency* and *material weakness* as related to the financial statements.

    b. A statement expressing that the purpose of the audit was not for the auditor to express an opinion on the financial statements.

    c. A statement that the auditor identified all the significant deficiencies and material weaknesses in the company's financial statements.

    d. A statement giving the company authorization to use the audit report on an as needed basis for financing and contracts.

39. According to AU-C 265.13, the auditor has how many days after the report release date to make the required communications?

    a. 30.

    b. 60.

    c. 90.

    d. 120.

40. Which of the following is correct regarding the communication of other internal control deficiencies that the auditor might discover in the audit?

    a. The management letter is an appropriate place for the auditor to address other internal control deficiencies.

    b. The auditor must communicate the other internal control deficiencies to management even if they were communicated in prior period and management did not remedy them.

    c. The auditor is required to communicate other internal control deficiencies to management in writing.

    d. Do not select this answer choice.

GLOSSARY

Analytical procedures: Risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment.

Clearly trivial misstatements: Amount designated by the auditor before which misstatements need not be accumulated.

Commitment: Contractual obligations for a future expenditure.

Contingency: Existing conditions that create a current obligation that needs to be accrued or that might create an obligation in the future that needs to be disclosed in the financial statements.

Control deficiency: Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Deficiency in design: Exists when a control necessary to meet the control objectives is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

Deficiency in operation: Exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Estimate: An approximate calculation of quantity or degree or worth.

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts.

Flux analysis: A narrative explanation by financial statement caption of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period.

Fraud: The intentional misrepresentation or failure to disclose a material fact (or facts) that results in injury or loss to someone relying on it.

Likely misstatement: Misstatements that: (1) arise from differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate (judgmental misstatement) and (2) the auditor considers likely to exist based on extrapolation from audit evidence obtained (projected misstatement).

Litigation: A suite between adverse parties that is contested in court. It is a legal action.

Material weakness: A reportable condition in which the design or operation of specific elements of an entity's internal control structure do not reduce to a relatively low level the risk that material errors may occur and not be normally detected.

Materiality: The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Near term: A period of time not to exceed one year from the date of the financial statements.

Probable: The future event or events are likely to occur.

Reasonably possible: The change of the future event or events occurring is more than remote but less than likely.

Remote: The chance of the future event or events occurring is slight.

Significant deficiency: A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Subsequent event: An event occurring after the balance sheet date but prior to the issuance of the auditor's report, which has a material effect on the financial statements and therefore requires adjustment or disclosure in the statements.

Workpapers: Document the work done and conclusions reached by the auditor, showing procedures applied, tests performed, information obtained, and pertinent conclusions reached.

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This index is a list of general topics discussed in this course. More specific key word searches can be performed using the search feature of this PDF.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 1—Cash Balances, Property, Other Assets, and Liabilities and Equity (ASBTG181)

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4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Nonpublic Companies—Course 2—Risk Assessment Procedures and Planning (ASBTG182)

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Course Acronym: ASBTG182

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5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
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4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Self-study Course Evaluation

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1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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