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Companion to PPC's Guide to

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Interactive Self-study CPE

Companion to PPC's Guide to Audits of Local Governments

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INTRODUCTION

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

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COMPANION TO PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS

COURSE 1

RISK ASSESSMENT PROCEDURES AND PLANNING (ALGTG211)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses the risk assessment procedures and planning required for a governmental audit. Lesson 1 covers risk assessment and other planning procedures, obtaining an understanding of the entity and its environment, and obtaining an understanding of internal control. Lesson 2 discusses obtaining an understanding of both entity-level and activity level controls, the planning decisions and judgment an auditor makes in this type of engagement, fraud, compliance with laws and regulations, and planning the audit time estimate.
PUBLICATION/ REVISION DATE:	April 2021
RECOMMENDED FOR:	Users of *PPC's Guide to Audits of Local Governments*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of governmental 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. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's *Government Auditing Standards*.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by **April 30, 2022**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Risk Assessment and Other Planning Procedures, Understanding the Entity and Its Environment, and Understanding Internal Control

Completion of this lesson will enable you to:

- Identify the sequence of audit planning, special considerations for governmental units, and risk assessment and other planning procedures that may be needed in a governmental audit.

- Determine best practices for obtaining an understanding of the governmental entity and its environment.
- Recognize best practices for obtaining an understanding of a governmental entity's internal control.

Lesson 2—Understanding Entity-level and Activity-level Controls, Planning Decisions and Judgments, Fraud, Noncompliance with Laws and Regulations, and the Audit Time Estimate

Completion of this lesson will enable you to:

- Determine what an auditor should do to obtain an understanding of a governmental unit's entity-level and activity-level controls.
- Identify the planning decisions and judgments that an auditor may have to make in a governmental audit.
- Recognize how an auditor should address fraud and compliance with laws and regulations during a governmental audit and how to plan a time-efficient audit.

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Lesson 1: Risk Assessment and Other Planning Procedures, Understanding the Entity and Its Environment, and Understanding Internal Control

INTRODUCTION

The focus of this course is *general* planning decisions. General or preliminary planning is 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:

- Identify the sequence of audit planning, special considerations for governmental units, and risk assessment and other planning procedures that may be needed in a governmental audit.
- Determine best practices for obtaining an understanding of the governmental entity and its environment.
- Recognize best practices for obtaining an understanding of a governmental entity's internal control.

COVID-19 Planning Considerations

COVID-19 has disrupted most aspects of life around the world, and has many implications for auditing, including significant considerations in the planning and risk assessment phase of an audit. To help auditors identify and address those implications for the audit, the authors recommend that auditors review a list of factors related to the COVID-19 pandemic when identifying risks that could result in a material misstatement of the financial statements and planning the audit response. Some practice aids, such as those found in *PPC's Guide to Audits of Local Governments*, include detailed discussions on certain factors and can serve as a reference tool for use throughout the engagement. This course does not include a discussion of those COVID-19-related factors.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from COVID-19. However, in May 2020, SAS No. 141 was issued to delay the effective dates by one year for the recently issued SAS Nos. 134–140 and to provide relief to firms struggling with the ramifications of the COVID-19 pandemic. The GASB, AICPA, and other organizations have provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the resulting accounting and auditing issues. The resources can be found at **https://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174469582, https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center**, **https://www.gfoa.org/coronavirus**, and **https://checkpoint.riag.com/**.

Authoritative Literature

The following establish key requirements and provide guidance that affects preliminary audit planning:

a. AU-C 220B, *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 230B, *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 all other audit procedures.

c. AU-C 240B, *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 250B, *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 260B, *The Auditor's Communication With Those Charged With Governance*, establishes requirements for the auditor to communicate with those charged with governance.

f. AU-C 300B, *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 315B, *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 320B, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality as a basis 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 330B, *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 procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.

j. AU-C 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements relating to auditing accounting estimates.

k. AU-C 550, *Related Parties*, establishes specific additional audit requirements regarding related-party relationships and transactions.

l. AU-C 570B, *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.

m. AU-C 610B, *Using the Work of Internal Auditors*, provides guidance on (1) using the work of the internal audit function and (2) using internal auditors for direct assistance in the audit of financial statements.

Aspects of the following standards also affect audit planning:

a. AU-C 935B, *Compliance Audits*, provides guidance on applying GAAS in a compliance audit performed in accordance with generally accepted auditing standards, *Government Auditing Standards*, and a governmental audit requirement that requires an opinion on compliance, such as a Single Audit.

b. GAO *Government Auditing Standards, 2018 Revision* (Yellow Book), issued by the Comptroller General of the United States, establishes planning and other field work standards.

c. AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), describes considerations that influence the planning of an audit of a governmental unit.

d. AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), provides guidance on performing Yellow Book audits and Single Audits.

These authoritative pronouncements are explained further at the relevant points in this course.

Objectives of Audit Planning

Planning an audit, according to AU-C 300B.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 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 315B.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 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. The authors believe it is useful to classify the audit requirements related to planning in the following categories:

- Procedures performed.
- Understanding obtained.
- Decisions and judgments made.

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 240B, *Consideration of Fraud in a Financial Statement Audit*, 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 240B are addressed at relevant points throughout this course.

Understanding Obtained. As explained in detail later in this lesson, 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, including its opinion units.

c. Objectives and strategies and the related business risks that may result in a material misstatement of the amounts and disclosures in an opinion unit financial statements.

d. Measurement and review of the entity's financial performance.

e. Internal control, including 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 opinion unit financial statement and relevant assertion levels.

Summary of Risk Assessment Process. Exhibit 1-1 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

Exhibit 1-1

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.	<u>Decisions at the Financial Statement Level:</u> • Materiality at the opinion unit financial statement level. • Materiality for particular items of lesser amounts. • Risks of material misstatement at the opinion unit financial statement level. • Overall audit strategy. <u>Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level:</u> • 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 begins with engagement acceptance and continues throughout the remainder of the audit. 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 authors' approach is presented in Exhibit 1-2.

Exhibit 1-2

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 a 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 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 risks of material misstatements 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 risks of material misstatement in relation to relevant assertions for transaction classes, account balances, and disclosures.
14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

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 1-2, 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.

Specialized Considerations for Governmental Units

Opinion Units. In the audit of a governmental entity, the auditor's planning and risk assessment activities need to take into account the government's various opinion units because the auditor issues an opinion on each opinion unit, which comprise the entity as a whole. For example, where item 6 in Exhibit 1-2 refers to determining the materiality level for the financial statements as a whole, that determination needs to be made for the financial statements of each opinion unit. Also, where item 10 refers to assessing risks of material misstatements at the overall financial statement level, that assessment, too, needs to consider each opinion unit separately.

The auditor also needs to determine whether all required major funds are separately displayed in the fund financial statements. Governments are permitted (but not required) to report as a major fund any additional governmental or enterprise funds that do not meet the quantitative criteria. The auditor does not need to evaluate management's judgment in determining additional funds to report as major. Also, because the standards for selecting major funds could result in different funds being reported as major each year, the auditor may need to consider performing procedures on the opening balances (especially equity) of major funds that were not audited as major in the previous year.

Because governments usually maintain multiple funds, audit procedures may be most efficient if they are designed to avoid repetitive procedures; that is, if procedures are performed across funds (or across opinion units). However, it may be necessary to perform separate procedures on activities that are operated separately or autonomously.

Most governments maintain their primary accounting records based on funds and separately develop the additional information needed for the government-wide financial statements. Because of this, it may be more efficient to plan and perform the audit by considering the fund financial statements first and then considering the additional information developed for the government-wide financial statements. In doing so, the auditor should obtain a sufficient understanding of the different processes and internal control over that additional information. SLG, Paragraph 4.37, clarifies that the auditor's responsibility for considering the processes and internal control over the additional information developed for the government-wide financial statements is the same as the responsibility for considering the processes and internal control over the fund financial statements.

Required Supplementary Information. A government's basic financial statements are always accompanied by MD&A and may also be accompanied by other information presented outside the basic financial statements. Information that GAAP requires to accompany the basic financial statements is referred to as required supplementary information (RSI). Common RSI for governments includes the MD&A, pension and OPEB funding information, budgetary comparison information, and information related to infrastructure reported under the modified approach. The auditor needs to consider what RSI is required in the circumstances, and, unless specifically engaged to audit the RSI, apply certain limited procedures to the information.

Other Unique Characteristics of Governmental Units. Governmental units have other unique characteristics that auditors need to consider, especially when updating their knowledge about the entity and its environment in a continuing engagement. The auditor might need to consider changes in the following:

- Component units.
- Funds (including whether different funds are reported as major funds).
- Property tax rates.
- Utility rates.
- Programs.
- Grantors.
- Impact of the economy on income, sales, and property taxes.

- Compliance requirements, including Single Audit and other governmental requirements.

During the risk assessment process, the auditor also might want to consider the following characteristics of governments:

- Governing body meetings are usually open to the public, and:
  - Senior management and the governing body are subject to political influences because they are elected officials or report to elected officials.
  - Governing body and management decisions as well as otherwise seemingly insignificant matters may be scrutinized by voters and the media.
  - Elected officials may focus on solutions that are popular with voters and make decisions that benefit the government in the short-term rather than the long-term.
  - Elected officials may expend excess revenues during periods of economic growth rather than reserve them for future shortfalls.
- Management and governing body actions may be mandated or affected in other ways by laws, regulations, and provisions of contracts and grant agreements.
- Unfunded mandates combined with limited financial resources and/or limitations on the ability to create new revenue sources may lead officials to ask management and staff to do more with less.
- The hierarchical structure of governments in general, and certain functions specifically, may create an environment that is inflexible or resistant to change. For example:
  - Generous retirement benefits and a disciplinary structure that requires several layers of approval may result in a stable work force even though salaries are often below the private sector.
  - An organized labor force in important functions such as public safety, public works, education, and health care may lead to fiscal stress when revenues are flat or declining.
- Management or those charged with governance have to respond to results of audits and regulatory and grantor reviews.
- GAAP financial statements should conform to GASB standards and at times governmental financial statements are required to conform to accounting and financial reporting requirements established by another government with financial reporting oversight responsibilities.

Outside Interest in Financial Statements. A high level of outside interest in the financial statements generally occurs because of the public nature of government in general; legal, regulatory, and contractual requirements related to bond issuances; and regulatory requirements related to federal financial awards. Some examples of outside parties interested in the financial statements of governmental units include citizens, employee groups, grantor agencies with special compliance requirements (for example, Single Audit requirements), other governments (such as state legislatures), investors, and public watchdog groups that compare and analyze governmental units' financial results.

Yellow Book and Compliance Audit Requirements. In addition to a GAAS financial statement audit, many governmental entities have a financial audit performed under *Government Auditing Standards* and, possibly, a Single Audit or other governmental compliance audit requirement. If this is the case, the audit will be subject to several additional requirements, some of which affect planning and risk assessment activities. Such additional requirements are discussed where relevant throughout this course.

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 1-2. Steps 1 through 3, the steps on preliminary engagement activities, and steps 13 and 14, the steps for detailed audit planning in relation to relevant assertions for transaction classes, account balances, and disclosures, are beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Local Governments*.

Lesson 1 covers the following topics:

- Risk assessment and other planning procedures.
- The understanding of the governmental unit and its environment (excluding internal control).
- The general requirements for obtaining an understanding of internal control and a suggested approach.

RISK ASSESSMENT PROCEDURES AND OTHER PLANNING PROCEDURES

AU-C 315B.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.

The auditor needs to consider opinion units in the audit, including during the planning and risk assessment activities. SLG, Paragraph 4.59, indicates that in the audit of a governmental entity, the assessment of risks at the financial statement level is at the level of each opinion unit. SLG, Paragraph 4.74, reminds auditors that the opinion units are (as applicable) the governmental activities, business-type activities, aggregate discretely presented component units, each major governmental fund, each major enterprise fund, and the aggregate remaining fund information (nonmajor governmental and enterprise funds, internal service funds, and fiduciary funds).

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.

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, 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 300B and AU-C 315B 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 organization and those charged with governance.
c. Analytical procedures.

d. Observation and inspection. [Examples of such procedures include visits to the entity's premises, review of governing board minutes, 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 of the entity and its environment 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 (including the individual statements and disclosures) to material misstatement is required by AU-C 315B.11. Additionally, AU-C 240B.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 responsible officials 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. 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 governmental industry, auditors may become aware of information that is relevant to identifying fraud risks. In addition, AU-C 240B.17–.24 explains that auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management, others in the governmental unit, and those charged with governance 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, such as identified inherent risks and information resulting from the discussion among engagement team members, client acceptance and continuance procedures, and reviews of interim financial statements.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Because 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 be used in identifying risks of material misstatement? The answer to both questions is a qualified "yes."

The process of understanding the client's operations and the governmental 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 also contributes to the understanding of the entity and its environment. For example, in previous audits the auditor may have learned whether:

- The government maintains current accounting policies and procedures manuals.
- Reports required by state or federal agencies are submitted on a timely basis.
- Internal control weaknesses or compliance findings are resolved on a timely basis.

- The government maintains its day-to-day accounting records on a cash basis and converts the financial statements to a GAAP basis only at year end. (If a governmental entity does not follow GAAP during the year and attempts to record material correcting entries at year end, there may be an increased risk that the financial statements will be materially misstated.)

Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The entity's organizational structure, 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 315B.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; services; contingencies; facilities; nature of the operations; management; financial condition; budgetary 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 operating risk or the auditor's assessment of risks of material misstatement. Therefore, the auditor performs some 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 may perform inquiries of client management and key client personnel, including personnel outside of 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. (Lesson 2 provides further discussion on the frequency of performing walkthroughs.)

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 to the entity or its environment.
- Reliability of evidence that is available to support conclusions about any changes from the prior period.

Although the auditor's procedures always include inquiries, observation, and inspection, the authors believe the extent of risk assessment procedures will often 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 earlier in this section 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 315B.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. In a governmental unit, the executive and legislative branches may share management responsibilities.

Although inquiry is a critical risk assessment procedure, inquiry cannot be used alone when identifying and assessing risks. Auditors are to use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, 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 organization about the following matters relevant to audit planning:

a. The entity and its environment as enumerated in AU-C 315B.

b. Fraud-related matters as enumerated in AU-C 240B.

c. Related parties and related-party transactions as enumerated in AU-C 550.

d. Accounting estimates as enumerated in AU-C 540B.

e. Compliance with laws and regulations as enumerated in AU-C 250B.

f. 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 570B.

Examples of responsible officials that auditors may consider interviewing include:

- The chief executive officer (mayor, city manager, etc.).
- The chief financial officer.
- The controller.
- Grant or programs director.
- Director of human resources.
- Director of information technology.
- Component management (if applicable).

In addition to other inquiries discussed in this section, the auditor might consider asking responsible officials questions such as the following:

- Does the government rely heavily on income from a single source (such as income taxes, sales tax or property taxes), and how likely is it that these sources have been or might be negatively impacted (for instance, due to a poor economy)?
- Have changes in the local economy affected major taxpayers or major utility customers?
- Are bond rating agencies considering changing the government's bond rating?

- Have there been changes in the terms or volume of federal awards (for example, are the awards suddenly for shorter terms or are the awards being phased out)?
- What were the results of grantor agency reviews?

In addition to inquiries of management, 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 the financial statements are used. AU-C 240.21, as amended by SAS No. 135, 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; their knowledge of actual, suspected, or alleged fraud; and whether the entity entered into significant unusual transactions.

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 315B.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, as amended by SAS No. 135, requires inquiry of internal audit personnel about risks of fraud, knowledge of actual, suspected, or alleged fraud, and activities concerning fraud detection, whether management satisfactorily responded to any findings, and whether the entity entered into significant unusual transactions.

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. AU-C 240B.A18–.19 and AU-C 315B.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 240B.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, and the meaning of contract terms.

   (3) *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.

   (4) *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, if any, that management has engaged.

***Government Auditing Standards* Requirements.** *Government Auditing Standards* indicates that auditors should make inquiries about findings and recommendations from previous engagements and evaluate whether appropriate corrective actions have been taken to address findings that could have a material effect on the financial statements. (AU-C 935B, *Compliance Audits*, has similar requirements for findings that could have a material effect on compliance.) The Yellow Book, at Paragraph 6.11, states that auditors should ask management "to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented." Auditors should use this information when assessing risk and determining the nature, timing, and extent of audit work, including the testing of implementation of corrective actions.

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 315B.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 240B.15 notes that the discussion among the engagement team required by AU-C 315B should include fraud brainstorming. AU-C 315B.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 240B.17–.18, should include the following specific areas of inquiry:

a. Whether they have knowledge of any actual, suspected, or alleged fraud.

b. Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.

c. The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.

d. Any specific risks of fraud that management has identified or that have been brought to its attention.

e. The classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.

f. 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.

g. Whether any significant unusual transactions have been entered into; if so, the nature, terms, and business purpose (or lack thereof); and whether such transactions involved related parties.

The areas of inquiry required by AU-C 240B 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 240B.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 themselves are far less meaningful than with respect to perpetration by lower levels within the entity. The objective of the inquiry includes obtaining different perspectives on financial statement areas and organizational areas and locations with a risk of fraud and identifying whether anyone has suspicions or actual knowledge of fraud.

Exhibit 1-3 presents a list of questions about fraud risks the auditor might consider asking the responsible officials of a governmental unit.

Exhibit 1-3

Inquiries about Fraud Risks for Responsible Officials

Recommended Areas of Inquiry	Possible Questions
Knowledge of any actual fraud or suspicions of fraud affecting the governmental unit.	• Are you aware of any actual instances of fraud within the governmental unit? • Do you have any reason to suspect fraud may be occurring within the governmental unit? If so, where and how? • Have you seen any changes in employee behavior?
Awareness of any allegations of fraud or suspected fraud affecting the governmental unit.	• Have you received any communications from employees, former employees, regulators, or others alleging fraud?

Recommended Areas of Inquiry	Possible Questions
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 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 result in 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 revenue, how would they do it? • If someone were going to steal and cover it up, how would they do it? • Does the governmental unit 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? What departures from GAAP are most likely? • Where are the weaknesses in internal controls? • Which controls can be bypassed or overridden? Are there instances where controls have been bypassed or overridden in the past? • Have other governments identified any common frauds? • Have there been changes within governments in general or their activities that have created or changed risks of fraud?
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? • How do you make it clear to employees that fraudulent or unethical behavior will not be tolerated?

Recommended Areas of Inquiry	Possible Questions
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 governmental unit? • 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 significant unusual transactions? • How have employees been told to communicate suspected fraud? • Are there any other programs and controls in place to help prevent, deter, or detect fraud? • How do you monitor the governmental unit's antifraud programs and controls to make sure they are working as intended? • Which types of transactions, account balances, financial statement classifications, or locations are most at risk for intentional misstatement or theft? • Have you identified any specific risks of fraud within the governmental unit?
The nature, terms, and business purpose (or lack thereof) of any significant unusual transactions entered into by the entity; and whether such transactions involved related parties.	• Are you aware of the entity entering any significant unusual transactions, including transactions involving related parties? • If so, what are the nature, terms, and business purpose of the significant unusual transactions?
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 government locations or components? • How do you monitor the governmental unit'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 governing body or audit committee about how the governmental unit's internal control serves to prevent, deter, and detect material misstatements due to fraud?

AU-C 240.21, as amended by SAS No. 135, 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; whether they have knowledge of any actual, suspected, or alleged instances of fraud; and whether the entity has entered into any significant unusual transactions. 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 governmental unit's fraud risk assessment and monitoring process. (A discussion of fraud inquiry techniques is outside the scope of this course.) Also, AU-C 315.06 and AU-C 240.19, as amended by SAS No. 135, require inquiries of appropriate internal audit personnel concerning risks of material misstatement (due to fraud or error) and other matters related to fraud, including whether the entity has entered into any significant unusual transactions. According to AU-C 315.A12, appropriate individuals are those whom the independent auditor concludes have appropriate knowledge, experience, and authority.

The auditor may 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 governmental unit?
- Do you have any reason to suspect fraud is occurring within the governmental unit? If so, where and how?
- Do you have any reason to suspect your superior is committing fraud?

See Exhibit 1-4 for additional illustrative questions that might be appropriate for employees of different levels and departments.

AU-C 240B.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. The authors believe that these inquiries might be combined with inquiries such as those in Exhibit 1-4 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.

Exhibit 1-4

Possible Inquiries about Fraud Risk for Government Employees

Suggested Questions	Direct Inquiries to
• Do you know of anyone who is stealing from the governmental unit? • Do you suspect that anyone is stealing from the governmental unit? • Do you know of anyone who is manipulating the accounts or records? • How could someone steal from the governmental unit without getting caught? • If I were to _[indicate potential fraud]_, how would I get caught? • How would you describe the governmental unit'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 governmental unit 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 governmental unit 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 governmental unit 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 accounting system or records? • Has anyone you work with ever asked you to withhold information from the auditors or alter documents or records? • Has the governmental unit 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 governmental unit that was illegal or unethical?	All employees selected

Suggested Questions	Direct Inquiries to
• How is management and/or the governing body 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? • 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 internal controls? • Do any of the 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 anyone run personal expenses through the governmental unit? • What aspect of the governmental unit'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 the governmental unit'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
• Have relationships 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

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 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 communication and support of the governmental unit's values or ethics.

Because management 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. Also, additional audit evidence may be necessary to resolve any inconsistencies among responses.

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 and AU-C 550.15, as amended by SAS No. 135, require the auditor to inquire of management and others within the entity about the following:

- Identity of related parties, including changes from the prior period.
- Nature of related-party relationships, including ownership structure.
- The business purpose for entering into a transaction with a related party versus an unrelated party.
- Whether there were any transactions, including modified or terminated transactions, with those related parties during the period and, if so, the transaction types and business purpose.
- Any related-party transactions that have not been authorized and approved in accordance with the entity's established related-party policies or procedures.
- Any related-party transactions that are exceptions to the entity's policies or procedures and the reasons for granting those exceptions.

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 established to—

- Identify, account for, and disclose related-party relationships and transactions.
- Authorize and approve significant related-party transactions and arrangements.
- Authorize and approve significant transactions and arrangements outside the normal course of business.

A discussion on obtaining an understanding of internal control appears later in this lesson.

AU-C 550.16, as amended by SAS No. 135, requires the auditor to inquire of those charged with governance, unless all are involved in management, about:

- Understanding of significant relationships and transaction with related parties.
- Concerns they may have regarding the relationships and transactions with related parties and the substance of those concerns.

Going Concern Uncertainty Inquiries. AU-C 570B.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.

Inquiries about Accounting Estimates. Because of the nature of accounting estimates, there can be a high degree of estimation uncertainty. AU-C 540B.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 540B.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 within 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.

Documentation of Inquiries. There are no specific documentation requirements for inquiries made as risk assessment procedures, but AU-C 230B provides pertinent guidance. AU-C 230B.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 230B.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. The authors recommend documenting such matter when performing risk assessment inquiry procedures.

Analytical Procedures

AU-C 315B.06 specifies that the risk assessment procedures should include analytical procedures, and AU-C 315B.A14 notes that analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information. AU-C 315B.A15–.A16 explains 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 entity and the industry 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 operations and industry and 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 operations before performing preliminary analytical procedures. 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.

SLG, Paragraph 4.45, indicates that the auditor should perform analytical procedures during audit planning for each opinion unit. For example, the auditor could compare the general fund's actual results to the budget, even if the budgetary comparison information is not presented as a basic financial statement. Another example would be comparing general and special revenue fund expenditures by functions and revenue by source for the past five years. This provides an understanding of the governmental unit's operations and may identify a revenue source that requires increased attention in the current audit.

Other than the analytical procedures performed to comply with AU-C 240B, as discussed below, 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 governmental unit, 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.

In the audits of governmental units, the auditor may have a sufficient understanding of the client and its operations to judgmentally consider the expected relationships. A precise quantification of these relationships may not be required or cost-effective, 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.

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. Auditors can concentrate on fluctuations in accounts that have not typically needed adjustments in the past.

b. *Look at Ratios That Should Not Change.* Examine areas where major adjustments are not expected.

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. 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. 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.

Well-designed preliminary analytical procedures based on appropriate expectations of plausible relationships can be 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.) As previously explained, AU-C 315B.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.

Preliminary analytical procedures may also identify declining trends in tax or revenue base (such as population, school enrollment, retail sales) or significant deficits in fund balance or net position 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.

Analytical Procedures Related to Revenue. In addition to the requirement in AU-C 315B to perform analytical procedures as part of risk assessment procedures, AU-C 240B.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. SLG, Chapter 4, Appendix A, paragraph A-8 provides the following examples of unusual or unexpected relationships relating to revenue that may indicate a material misstatement due to fraud:

- Actual revenues vary significantly from revenues originally budgeted.
- Actual revenues vary significantly from prior-period revenues without similar changes in the revenue base or rates applied to the base.
- A significant increase in actual revenues over those of the prior period that prevents the government from reporting annual or accumulated fund balance or net position deficits, or from violating debt covenants.
- Large "miscellaneous" or "one-time" revenues.
- Significant differences in resources received in advance and deferred inflows of resources from the prior-period.
- No reduction in the asset account when recording revenue from selling an asset.
- Investment income that varies from market conditions.
- Expenditure driven grant revenue without grant expenditures to offset.

As indicated in AU-C 240B.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.

ADA Guide. The AICPA has issued *Guide to Audit Data Analytics (ADA Guide)*, which provides an introduction and overview of data analytic techniques that can be used by financial statement auditors. The *ADA Guide* provides a chapter on using data analytic techniques in the performance of risk assessment procedures along with relevant examples. The *ADA Guide* can be purchased at **www.aicpastore.com/**.

Observation and Inspection

According to AU-C 315B.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, to gain an understanding of the client's financing arrangements and underlying covenants, the auditor may review the client's bond agreements and other related documents. That procedure, coupled with a review of the client's financial statements, may provide key information that helps the auditor identify risks related to potential noncompliance with bond 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.

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. The authors believe that observation and inspection procedures are ordinarily 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.
- 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.

Documentation. AU-C 230B.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 230B.A14 provides examples of how this might be accomplished. Based on that guidance, the authors recommend documenting 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, the authors recommend 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 315B.11 requires key members of the audit team including the engagement partner to discuss the susceptibility of the entity's financial statements to material misstatements. AU-C 315B.11 also requires discussion of the applicability of GAAP to the entity's facts and circumstances. AU-C 240B.15 requires an 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 a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

AU-C 315B.A22 indicates that, in performing the engagement team discussion:

- More experienced team members (including the partner) can share their insights about the organization.
- Team members exchange information about the organization'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 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 315B.11 states that the engagement partner and key engagement members should take part in the team discussion. In addition, the engagement partner should determine the matters to be communicated to team members who are not involved in the team discussion.

Matters to Be Discussed. This discussion is aimed at the susceptibility of the financial statements to material misstatement and the application of GAAP to the entity's facts and circumstances; 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:

- Information about the engagement provided by the engagement partner as part of his or her responsibility to direct the engagement team.
- Related-party relationships and transactions.
- The susceptibility of the entity's financial statements to material misstatement.
- Application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- 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. Unusual accounting practices used by the client.
c. Implementation of new accounting standards.
d. Changes in the entity's environment, financial condition, or activities that may result in significant new or revised accounting or disclosures.
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 at the opinion unit (i.e., financial statement level) (planning materiality) and at the account level (performance materiality).
i. How materiality will be used to determine the extent of testing.
j. 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.

The authors believe the discussion also needs to address how the operating 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.

Examples of other factors that affect the likelihood of material misstatements caused by error that the engagement team might discuss include the following:

- Past experience with the client (including areas with audit difficulty, amounts or disclosures, for which it was difficult to obtain sufficient appropriate evidence, and misstatements encountered).
- Changes in the client's organization (for example, changes in personnel or accounting systems).
- The nature and complexity of transactions and/or disclosures (including those involving significant judgment from management on how much information to include in disclosures).
- 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.

Engagement Partner Information. AU-C 220B.17 requires the engagement partner to take responsibility for the direction, supervision, and performance of the audit engagement, while AU-C 220B.A12 further clarifies that direction of the engagement team involves informing team members of certain matters. The engagement partner 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.

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 indicate that the team discussion might discuss 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 authors recommend that the discussion include reminding 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 550.25 to promptly communicate such information to other team members. Also, AU-C 550.25 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 240B.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, transaction classes, or disclosures) might be susceptible to material misstatement due to fraud.
- For areas susceptible to material misstatement due to fraud, the methods management might use to conceal the 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 manipulation of the budget or other financial measures.
- Practices management might use to manipulate the budget 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. For example, is management under pressure to meet the legal operating budget and to maintain specified fund balance reserves? (This could result in pressure to overstate revenues and understate expenditures.) Are there adequate, effective controls over police vehicle parts, such as tires and batteries, which are portable and easily stolen?

AU-C 240B.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 and/or disclosures that would be affected and the nature of procedures that could be performed to address the risks.

The discussion should be an open exchange of ideas. AU-C 240B.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 240B and AU-C 315B, respectively, 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 240B.15 indicates that communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit, particularly upon discovery of new facts.

AU-C 240B.12 indicates that, in accordance with AU-C 200B, 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. *Professional skepticism* has always been viewed as an attitude that includes a questioning mind. AU-C 200B.14 expands on this to include 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 200B.A26, a belief that management and those charged with governance are honest and have integrity does not allow the auditor to be satisfied with less than persuasive audit evidence.

Sample Questions. Exhibit 1-5 represents a list of sample questions that might be considered during the engagement team discussion.

Exhibit 1-5

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?
  - Revenue and services?
  - Taxpayer base and demand for services?
  - 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?
- Are there any changes in the environment, financial condition, or activities that may result in significant new or revised accounting or disclosures?
- 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 entity 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?
- How could related parties be involved in committing fraud?
- Which individuals in the entity have the opportunity to steal assets?
- Are there any known pressures that would motivate employees with opportunity to steal assets?
- Which assets of the entity 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 entity?
- How could financial statement accounts be materially misstated by stealing assets?
- How would *you* conceal theft of assets at this client?
- What factors might indicate that the entity 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 entity 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, the authors recommend that the engagement team 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. 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? Only 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 statements to material misstatements from error or fraud. The authors recommend 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 the authors recommend that the in-charge auditor and/or engagement partner 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 operating environment (particularly changes from the prior year), the client's view of the operating risks that the client is addressing, and other specific issues facing the client.

AU-C 240B and AU-C 315B make it 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. The authors recommend holding the discussion prior to performing the information-gathering procedures related to obtaining an understanding of the entity and its environment, as discussed later in this lesson. The authors believe it is important to set the proper tone of professional skepticism and to 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.

Documentation. AU-C 315B.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 opinion unit and relevant assertion levels.

As explained in Lesson 2, AU-C 240B imposes additional documentation requirements related to the fraud aspects of the discussion. One method for documenting the discussion among the engagement team regarding the susceptibility of the financial statements to material misstatement due to error or fraud is by using practice aids such as those provided in *PPC's Guide to Audits of Local Governments*.

Other Sources of Information for Identifying Risks of Material Information

In addition to the risk assessment procedures discussed previously, the auditor considers other sources of information as follows:

a. AU-C 315B.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 315B.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.

The authors believe that it would be worthwhile to consider whether any engagements performed for the entity, no matter who was the engagement partner, could provide information relevant to identifying risks of material misstatement.

In addition, the auditor may obtain information from sources outside the entity that is useful in understanding the client and identifying risks of material misstatement. Such sources might include:

- The client's external legal counsel.
- Regulatory publications.
- Reports of service organizations.
- Experts used by the client that are relevant to financial reporting purposes, such as a valuation expert.

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 steps is considered part of the general audit planning at the financial statement level?
   a. Determining the client's performance materiality.
   b. Establishing an understanding with the client.
   c. Performing acceptance or continuance procedures.
   d. Holding a discussion with the engagement team.
2. Which of the following considerations applies specifically to the audit of a governmental unit?
   a. The auditor's planning and risk assessment activities should be focused on the governmental entity as a whole.
   b. The auditor should determine whether the government has correctly identified and presented any additional major funds.
   c. When possible, auditors should plan to perform audit procedures across funds or opinion units to increase efficiency.
   d. If required supplementary information (RSI) is included, the auditor should treat it the same way as other information included in the audit engagement.
3. Audit procedures performed in a prior-year audit may provide useful evidence about which of the following?
   a. The entity's organizational structure.
   b. Current-year misstatements.
   c. Walkthroughs.
   d. Inquiries of management and others.
4. To whom might an auditor address inquiries about the client's selection and application of accounting policies?
   a. Those charged with governance.
   b. Information technology (IT) systems personnel.
   c. In-house legal counsel.
   d. Financial reporting personnel.
5. Which of the following matters is specifically required to be discussed during the engagement team discussion?
   a. How operating risks facing the client could result in a material misstatement.
   b. How susceptible the financial statements are to misstatement.
   c. Information about the engagement provided by third parties.
   d. The client's unusual accounting practices.

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 steps is considered part of the general audit planning at the financial statement level? **(Page 7)**

   a. Determining the client's performance materiality. [This answer is incorrect. Though this may be done in conjunction with steps at the general audit planning at the financial statement level, determining performance materiality is considered detailed audit planning at the relevant assertion level for account balances, transaction classes, and disclosures.]

   b. Establishing an understanding with the client. [This answer is incorrect. Establishing an understanding with the client and communicating it to them in an engagement letter is considered a preliminary engagement activity rather than part of general audit planning at the financial statement level.]

   c. Performing acceptance or continuance procedures. [This answer is incorrect. Preliminary engagement activities include performing procedures regarding acceptance or continuance of the client relationship and the specific audit engagement. This is not included as part of general audit planning at the financial statement level.]

   d. **Holding a discussion with the engagement team. [This answer is correct. General audit planning at the financial statement level includes several steps, including performing preliminary analytical procedures; holding a discussion among the engagement team; and identifying fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks of material misstatement.]**

2. Which of the following considerations applies specifically to the audit of a governmental unit? **(Page 8)**

   a. The auditor's planning and risk assessment activities should be focused on the governmental entity as a whole. [This answer is incorrect. In the audit of a governmental entity, the auditor's planning and risk assessment activities need to take into account the government's various opinion units because the auditor issues an opinion on each opinion unit, which comprise the entity as a whole.]

   b. The auditor should determine whether the government has correctly identified and presented any additional major funds. [This answer is incorrect. The auditor needs to determine whether all required major funds are separately displayed in the fund financial statements. Governments are permitted (but not required) to report as a major fund any additional governmental or enterprise funds that do not meet the quantitative data. The auditor does *not* need to evaluate management's judgment in determining additional funds to report as major.]

   c. **When possible, auditors should plan to perform audit procedures across funds or opinion units to increase efficiency. [This answer is correct. Because governments usually maintain multiple funds, audit procedures may be most efficient if they are designed to avoid repetitive procedures; that is, if procedures are performed across funds (or across opinion units). However, it may be necessary to perform separate procedures on activities that are operated separately or autonomously.]**

   d. If required supplementary information (RSI) is included, the auditor should treat it the same way as other information included in the audit engagement. [This answer is incorrect. The auditor needs to consider what RSI is required for the government in the circumstances, and, unless specifically engaged to audit the RSI, apply only certain limited procedures to the information.]

3. Audit procedures performed in a prior-year audit may provide useful evidence about which of the following? **(Page 12)**

   a. **The entity's organizational structure. [This answer is correct. The process of understanding the client's operations and the governmental industry is continual. A significant amount of**

knowledge is gained during the audit. The auditor's previous experience with the entity also contributes to the understanding of the entity and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about items including the entity's organizational structure, controls, and operations.]

b. Current-year misstatements. [This answer is incorrect. Audit procedures from previous audits will likely provide useful audit evidence about past misstatements and whether they were corrected on a timely basis. Information about past misstatements assists the auditor in assessing risks of material misstatement in the current audit, but it does not specifically allow auditors to find the current-year misstatements. That will take other procedures, as well.]

c. Walkthroughs. [This answer is incorrect. Walkthroughs are something auditors typically perform during every engagement. An auditor would not have enough evidence to express his or her opinion if relying solely on prior-year walkthroughs.]

d. Inquiries of management and others. [This answer is incorrect. The auditor's procedures will always include inquiries, observation, and inspection. Therefore, the auditor cannot rely solely on prior-year information and avoiding making current-year inquiries.]

4. To whom might an auditor address inquiries about the client's selection and application of accounting policies? **(Page 14)**

a. Those charged with governance. [This answer is incorrect. Inquiries to those charged with governance should address their involvement in the financial reporting process and how the financial statements are used. AU-C 240.21, as amended by SAS No. 135, 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; their knowledge of actual, suspected, or alleged fraud; and whether the entity entered into significant unusual transactions.]

b. Information technology (IT) systems personnel. [This answer is incorrect. Inquiries directed to IT systems personnel or users would typically be about 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.]

c. In-house legal counsel. [This answer is incorrect. Inquiries to the client's in-house legal counsel would typically address litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud, and the meaning of contract terms.]

d. **Financial reporting personnel. [This answer is correct. In additional to inquiries of management, inquiries of others within and outside the entity are either required or can provide useful information. The entity's financial reporting personnel can provide information about the appropriateness of the selection and application of accounting policies, including the initiation, authorization, processing, or recording of complex or unusual transactions. AU-C 240B.32 explicitly requires inquiries about knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.]**

5. Which of the following matters is specifically required to be discussed during the engagement team discussion? **(Page 26)**

a. How operating risks facing the client could result in a material misstatement. [This answer is incorrect. It is a best practice for the engagement team discussion to address how the operating 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. However, this is not one of the required topics.]

b. **How susceptible the financial statements are to misstatement. [This answer is correct. Certain matters are required to be a part of the engagement team discussion. Among such matters are (1) related-party relationships and transactions, (2) the susceptibility of the entity's financial statements to material misstatement, and (3) the application of GAAP to the entity's facts and circumstances in light of its accounting policies.]**

c. Information about the engagement provided by third parties. [This answer is incorrect. One of the matters that is specifically required to be discussed during the engagement team discussion is information about the engagement provided by the *engagement partner* as part of his or her responsibilities to direct the engagement team.]

d. The client's unusual accounting practices. [This answer is incorrect. In addition to focusing on areas of vulnerability, it is a best practice for the engagement discussion to include topics such as (1) critical issues and areas of significant audit risk, (2) unusual accounting practices used by the client, and (3) implementation of new accounting standards. However, this is not one of the required topics.]

OBTAINING AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT

The auditor, according to AU-C 315B.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 315B.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. 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.

The auditor's process in obtaining this understanding is focused on those matters that could cause material misstatement of an opinion unit, including potential 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 sense and indicate possible risk considerations.
- Considering fraud risk factors, for example, the existence of significant or complex related-party transactions.
- Evaluating the appropriateness and sufficiency of audit evidence.

The audit personnel working on a governmental engagement need to sufficiently understand the nature and structure of their client's operations sufficiently 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.

Components of the Understanding

AU-C 315B.12 indicates that the auditor's understanding of the entity and its environment consist of an understanding of the following items:

a. Industry, regulatory, and other external factors.

b. Nature of the entity, including its opinion units.

c. Objectives, strategies, and related business risks that may result in a material misstatement of an opinion unit.

d. Measurement and review of the entity's financial performance.

e. Selection and application of accounting policies.

In addition, the 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 previously, AU-C 315B.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.

Industry, Regulatory, and Other External Factors

AU-C 315B.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 government industry, degree of regulation, or other external forces, such as political, social, or technological forces. The following discussion highlights such matters that are particularly relevant for the audit of a governmental unit.

General Characteristics of a Governmental Unit That Influence Audit Approach. One characteristic of governmental units that has an overriding influence on audit approach is the lack of a profit motive and the corresponding expected relationship between revenues and expenses. Other characteristics of governmental units that have an important effect on audit approach are as follows:

- Many financial position statement account balances are relatively small dollar amounts in comparison to the level of revenues and expenditures in an annual period.
- There is high public interest and reaction to fraud, waste, and abuse involving governmental resources.
- Governmental entities often have material grants with significant restrictions. *Government Auditing Standards* require auditors to design their audits to provide reasonable assurance of detecting noncompliance with contracts or grant agreements that could have a material effect on the financial statements.
- The Single Audit Act requires the auditor to obtain an understanding of internal controls established to ensure compliance with laws and regulations affecting expenditures of federal awards and to perform tests of those controls.

These characteristics of governmental units mean that, compared to a nonpublic company audit, a governmental audit will have a more focused consideration on compliance with laws and regulations, a greater emphasis on transaction testing, and more concern with internal control. Also, a Single Audit includes requirements to report on compliance and internal control related to compliance with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major federal program. The report has to include an opinion on compliance.

SLG, paragraph 4.48, explains that information that may be useful in gaining an understanding of the government and its environment generally can be obtained from sources such as federal and state laws and regulations, local charters, budget documents, recent bond offerings, prior-period financial reports, the RFP for audit services, and discussions with management. This information might include:

- Developments that affect the governmental industry and the client in particular, including but not limited to, economic, legislative, regulatory, accounting, and auditing developments.
- The reporting entity's composition.
- The relationships and operations between the reporting entity and its component units.
- The form of government (e.g., a governing body with an elected mayor or a governing body with an appointed mayor) for both the primary government and its component units.
- Organizational structure, including information about top management, such as their identities and experience.
- Top management's relationships with other key managers and the governing body.
- Laws and regulations governing general operations of the government and its component units.
- The business rationale and nature of joint ventures, if any.

- Factors that might affect the government's operation (e.g., taxpayer initiatives that limit budget growth or additional services).
- Policies and the rationale for such policies for debt and investment management.
- How the budget is balanced in times of economic stress or decline.
- Audit committee's (or other group or individual charged with oversight of financial reporting) functions.
- How primary sources of revenue (e.g., property taxes, shared revenues, grants, contracts, and service charges) are received, and how transactions are authorized, initiated, recorded, and reported.
- The rationale for entering into complex, unusual, or risky activities.
- The services the government provides and the resources used for each function or program.
- How services (including in-kind services) provided by separate departments and independent entities (e.g., school districts or redevelopment agencies) relate to the government.
- Accounting and financial reporting requirements established by another government that has financial reporting oversight responsibilities.
- Accounting and financial reporting policies, procedures, and systems, including the number and nature of funds, when funds are established or eliminated, supplementary records that are maintained for capital assets and long-term debt, and the process by which information for the government-wide financial statements is produced from fund-based accounting data.
- The types of computer equipment used, personnel involved, and background information, including software packages and operating systems and how often their relevance and adequacy are reviewed.
- Prior period opinion modifications that could lead to opinion modifications in the current period.
- The status of previous deficiencies in internal control and, if applicable, the reasons why any were not corrected.
- Regulatory or oversight agencies findings.
- Prior-period findings, including findings and questioned costs that could require reporting of contingent liabilities.
- Compliance auditing requirements.
- Special reporting requirements.

Laws, Regulations, and Similar Requirements. The auditor should inquire of management and read pertinent statutes, regulations, and charter provisions and excerpt significant items for the permanent file section of the workpapers. Federal or state statutes and regulations may have an important influence on a local government's operations, control activities, or accounting system. The budgetary process and related legal requirements are particularly important. Also, the relationship of state and local laws to federal law and Single Audit requirements may be important. If any legal requirements require clarification, the auditor should request a written interpretation from the government's legal counsel.

AU-C 935B, *Compliance Audits*, indicates the auditor also might obtain information by:

a. Reading laws, regulations, rules, and provisions of contracts or grant agreements that relate to programs being audited.

b. Consulting the *OMB Compliance Supplement* or audit guides issued by grantor agencies.

c. Reading documentation of compliance requirements from previous audits or other engagements and, if applicable, discussing them with auditors who performed the prior audits or other engagements.

d. Making inquiries of management and other individuals (both inside and outside the entity).

e. Reading minutes of governing board meetings.

SLG, Paragraph 4.12, provides the following examples of the types of compliance requirements that could have a direct effect on the determination of material financial statement amounts and disclosures or noncompliance that may materially affect a governmental unit's financial statements:

- *GAAP Requirements.* Legal or contractual provisions may require GAAP basis financial statements.
- *Federal and State Taxes.* The government may be subject to federal or state tax requirements such as those relating to employment taxes, employee benefits, and tax-exempt debt (e.g., arbitrage rebate requirements).
- *Legal Authority for Transactions.* Governments may need legal authority to exercise certain powers or conduct certain activities. For example, a local government may not be able to levy property taxes unless specifically authorized to do so by state law.
- *Establishment of Funds.* Legal or contractual provisions may require the use of separate funds to account for and report on particular activities.
- *Budgets and Appropriation Laws.* Budgets and appropriations often specify that particular funds finance particular costs and establish the nature and amount of interfund activity. In addition, budgets and appropriations may specify spending limits that may not be exceeded without prior approval from a governing body.
- *Tax and Debt Limitations.* Legal provisions may limit taxing authority, place ceiling limitations and other issuance criteria on debt, or limit the use of debt proceeds.
- *Cash and Investments.* Governmental units often have legally limited deposit and investment options. For example, investments in derivative instruments, hedge funds, and debt instruments with long maturities might be prohibited.
- *Expenditure and Contracting Limitations.* Laws or regulations may prohibit purchasing certain products or services without open competitive bidding or may require following certain purchasing procedures.
- *Time and Other Eligibility Requirements and Purpose Restrictions on Nonexchange Transactions.* Failure to comply with a provider's eligibility requirements and purpose restrictions for nonexchange transactions may result in the provider withdrawing intended support or requesting a refund of amounts previously paid. Such requirements might also affect the recognition and reporting of nonexchange transactions.
- *Legal and Contract-based Compliance Requirements.* In addition to the compliance requirements previously discussed related to eligibility and purpose restrictions for nonexchange transactions, providers of such resources may impose other requirements such as specific procurement and cash management policies. There also may be contractual compliance requirements relating to exchange transactions, such as for debt issuances.

The compliance requirements listed in the previous paragraph may not materially affect financial statement amounts and disclosures for all governmental entities. Also, there may be other types of compliance requirements that do have a material effect.

Political Environment. Knowledge and understanding of the political environment is particularly important in a governmental engagement. Political considerations include both general and specific matters that may have an influence on the conduct of a governmental engagement. The visibility of governmental operations and related attention from the news media create both opportunities and problems. Media coverage of governmental operations is a potential additional source of information.

Reporting Requirements. The auditor should inquire of management and review bond covenants, grant requirements, requirements of higher levels of government (state, county, etc.), and pertinent statutes to identify the legal reporting requirements of the governmental unit. In a governmental engagement, legal reporting requirements may include requirements for both financial and nonfinancial information. Additional reports on compliance with laws and regulations and internal control are required by AU-C 935B, *Government Auditing Standards*, and the Single Audit Act.

Economic Environment. The auditor should consider both general and local economic trends and indicators. Factors such as unemployment rates, age and income demographics of the population, assessed values of real property, population trends, and local commercial economic indicators, such as retail sales, may influence the level and type of governmental activities. This type of information is available from local chambers of commerce or state economic agencies. Also, federal departments, such as Labor or Census, may be sources of useful economic information. Another important source of information for a governmental unit is bond rating agencies that rate securities of governments.

Economic Conditions. 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.

AICPA Audit Risk Alert on General Economic Matters. The AICPA Audit Risk Alert, *General Accounting and Auditing Developments—2020/21* (AICPA Risk Alert), helps auditors identify and respond to accounting and audit issues related to economic developments. An auditor needs to understand 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, industry, legislative, and regulatory developments.
- COVID-19 impact and audit implication.
- Accounting, auditing, and attestation issues and developments, including the enhancing audit quality initiative.
- Recent accounting, audit and attest, independence, and ethics developments, such as accounting for leases.
- The status of outstanding accounting, auditing, and attest projects.
- Various resources auditors may find useful.

Risk Assessment Procedures and Factors to Consider. The authors believe that in most situations 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.

Nature of the Entity

AU-C 315B.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 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 multiple locations or component units. Complex structures often give rise to risks of material misstatement. In addition, entities with complex structures often have special audit implications such as the requirements for audits of group financial statements. Matters that the auditor might consider about the entity's operations and its structure, and governance include the matters discussed in the following paragraphs.

Structure and Governance Characteristics. The structure of a governmental unit and its governance are affected by the allocation of administrative responsibilities. Administrative responsibilities may be shared by the executive and legislative branches. By inquiry and inspection of relevant documents, the auditor should obtain the following information:

- The authorities, responsibilities, and duties of the executive branch (e.g., mayor, city manager, county judge, superintendent of schools, etc.) and legislative branch (e.g., city council, county commissioners, board of education, etc.), and the relationship between the two branches.
- The composition of the legislative or governing body, including the composition and activities of an audit committee, if any.
- The organization of the executive branch, including overall and personnel organization charts.
- The authorities, duties, and responsibilities of key administrative and financial personnel, including formal position descriptions, if available.

Generally, a separate memorandum describing each of these organizational matters may be prepared for the permanent file and updated as necessary. Local governments often have a mayor and city council form of government or an appointed city manager. In some cases, the executive branch (mayor) may be strong and the legislative branch (council) weak, or the reverse may be true. The auditor should focus on who really makes the decisions, how the decisions are made, and what methods are used to communicate decisions.

Audit Committees. Many governmental units have established either an audit committee or a group of individuals formally designated with oversight of financial reporting. Auditors should determine whether there is such a group to which inquiries should be directed and communications made. *Government Auditing Standards*, as well as several AICPA Statements on Auditing Standards, have established requirements for auditor communication with audit committees (or others charged with governance).

Operating Characteristics. Based on inquiry, observation, and reading of relevant statutes and ordinances, the auditor should obtain an understanding of and document a general description of the following activities:

- Tax assessing procedures and procedures for other major sources of revenue and revenue management.
- Purchasing procedures.
- Treasury functions, including major financing sources, major investments, and use of high-risk or exotic investments.
- Budgeting procedures.
- Fund accounting requirements, including specified funds and overall fund structure.
- High potential risk operations; e.g., hospitals, landfills, social service programs, etc.

The budgeting process is particularly important in governmental operations. The budget allocates anticipated resources and, normally, expenditures exceeding budgeted amounts are legally prohibited. The auditor should obtain an understanding of the process for adopting and amending budgets, controlling expenditures, and monitoring adherence to budgets.

In a continuing engagement, the auditor should update knowledge of the government through discussions with key client personnel and review of interim financial reports and budgets. The auditor is interested in identifying changes in personnel; procedures; processes; contracts; services; contingencies; facilities; management; financial condition; budget pressures; conditions and events that are relevant to the going concern assumption; debt covenant compliance; litigation status; control environment or activities; fraud indicators; 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 alter the government's business risk or the auditor's assessment of audit risk.

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 who 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.

Objectives, Strategies, and Related Business Risks

AU-C 315B.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 risks eventually have financial consequences and, thus, an effect on the financial statements. Not all business risks create risks of material misstatement, so the auditor needs to focus on 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. The executive and legislative branches of government determine the 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 governmental unit's ability to achieve its objectives or implement its strategies.

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. 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.

SLG, Paragraph 4.138, Appendix A-11, provides the following examples of areas of risk of material misstatement for a governmental unit:

- Investment valuation where there is no market-established fair value.
- Receivable allowances valuation.
- Excessive or obsolete supplies inventory valuation.
- Interfund receivables/payables that are long outstanding, which may not represent valid rights and obligations.
- The recourse liability for receivables sold with recourse valuation.
- Liabilities for compensated absences, claims and judgments (including risk financing liabilities), termination benefits, pension benefits, OPEB, pollution remediation liabilities, and landfill closure and postclosure care costs valuation.
- The existence of restrictions on net position.
- Revenues classified as program versus general.
- The classification of interfund and internal activity and balances, including elimination of allocated expenses.
- Depreciation on capital assets, where applicable, especially those with long useful lives.
- Capital assets classified as land versus land improvements versus infrastructure assets that affect classification and allocation of costs.
- Specific conditions related to internally generated intangible assets that could affect the classification of the assets as either capital assets or expenses.

Also, SLG, Paragraph 4.138, Appendix A-12, explains that a state or local government's management might intentionally:

- Recognize significant revenues on a cash basis when they should be recognized on a modified accrual or accrual basis.
- Overstate or understate the allowance for uncollectible receivables.
- Delay recognition of protested taxes revenues until after the protest has run its course.
- Net revenues against expenses/expenditures even when there is no right of offset.
- Fail to net revenue against expenses/expenditures when appropriate, such as insurance recoveries received in the same year as an impairment loss.
- Recognize revenue from derived taxes based on receipt of cash rather than the occurrence of the underlying economic event.
- Recognize revenue from government-mandated or voluntary nonexchange transactions without considering eligibility requirements.
- Recognize revenue before it is realizable, such as from a legal judgment.

Measurement and Review of the Entity's Financial Performance

AU-C 315B.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. The measurement and review of financial performance for governmental entities generally relates to budget and program performance. 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 and variance analyses.

e. Budget-to-actual financial performance.

f. Period-on-period financial performance.

g. Employee performance measures.

h. Enterprise fund performance reports.

i. Comparisons to performance of similar local governmental units (i.e., benchmarking).

Information prepared by external parties would include bond 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 results 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.

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. As indicated above, management may have identified key financial performance indicators that it uses when managing the entity. As management reviews financial or other operating reports, a determination is made whether the governmental unit 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 bond rating agencies. If so, the auditor may review available reports to identify potential risks. A change in a governmental unit's bond rating is an important risk indicator.

Selection and Application of Accounting Policies and Accounting Estimates

AU-C 315B.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 activities and consistent with policies used in governmental financial reporting. AU-C 540B.08 indicates that the auditor should obtain an understanding of the following regarding accounting estimates:

- Requirements of the applicable financial reporting framework 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.

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.

The auditor's understanding of management's selection and application of accounting policies includes the following:

a. Relevant accounting standards and specific governmental accounting 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 (or a special purpose framework of accounting).

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, such as OPEB or landfill closure and postclosure costs.

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 unusual transaction there ordinarily is a higher risk of material misstatement for the account balance affected.

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 240B.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 manipulate budget and other financial information.
- Bias that may create a material misstatement.

AU-C 240B.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 activity 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 governmental industry.
- The auditor's knowledge and past experience with the governmental unit.
- The degree of financial reporting sophistication of the governmental unit.
- The extent of new accounting standards that are recently effective for the governmental unit.
- The auditor's participation in assisting with the selection of accounting policies and the preparation of the financial statements.

For many governments, the auditor is instrumental in assisting with selection of accounting principles and advising on the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process because 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 in which 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 listed above. 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 governmental industry or its transactions.

New Accounting Standards. Auditing standards emphasize the importance of consideration of an entity's implementation of new accounting standards in obtaining an understanding of the entity, assessing risks of material misstatement, and planning the audit. The Appendix at AU-C 300B.A27 identifies significant changes in the financial reporting framework, such as changes in accounting standards, as a significant factor to be considered in establishing the overall audit strategy. AU-C 315B.A36 explains that an understanding of the entity's selection and application of accounting policies includes financial reporting standards new to the entity and when and how it will adopt those requirements. Of particular importance, AU-C 315B.29b requires the auditor to consider whether the risk related to significant accounting developments is a significant risk necessitating special audit consideration. As part of risk assessment procedures and planning, an auditor needs to identify new accounting standards that the entity is required or has elected to adopt in the current period, and consider how the new standards and the method of their implementation affect the risks of material misstatement.

Among the important considerations that affect risk assessment and planning when an entity has adopted a new accounting standard are the following:

a. *Discuss in advance*. Before the period in which the new accounting guidance is implemented, discuss with management the changes in accounting policies and procedures, controls, and personnel that may be necessary.

b. *Evaluate adequacy of personnel*. The accounting personnel who were able to prepare financial statements in prior periods adequately may be challenged by the new accounting guidance. (An auditor may want to recommend additional training, additional personnel, or engaging a consultant.)

c. *Allow more time*. The risk assessment and planning step in the audit may require more time than in prior periods that had no changes in accounting principle.

d. *Focus on the transition*. Consider the additional steps that may be needed by management and in the audit to deal with transition requirements, including gathering required information and putting controls over the transition in place.

e. *Consider the effect of changes in controls*. New controls, or amendments of existing controls, may be necessary to ensure compliance with new accounting requirements. Requirements for new significant judgments, methods, and assumptions, particularly related to new estimates, may require new controls. Also, the absence of changes when needed will increase risks.

f. *Consider the effect changes in measurement of account balances may have*. If implementation of the new accounting standard causes the amount of account balances to change from what they would have been under prior guidance, there may be significant changes in the materiality benchmark, amounts used in analytical procedures, and key performance indicators.

Deferral of Effective Dates for Leases, Implementation Guides and Other New Standards. In May 8, 2020, the GASB issued GASBS No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, which defers the effective dates of the following Statements and Implementation Guides by one year: Statement Nos. 83; 84 and Implementation Guide 2019-2; 88; 89; 90; 91; certain provisions of GASBS Nos. 92 and 93; and certain questions in Implementation Guide 2017-3, Implementation Guide 2018-1, and Implementation Guide 2019-1. It defers the effective date of GASBS No. 87 and Implementation Guide 2019-3 by 18 months. The requirements of GASBS No.

95 are effective immediately. Early implementation is encouraged and is permitted to the extent specified in each pronouncement as originally issued.

Leases–GASBS No. 87. States and local governments are required to implement GASB No. 87, *Leases*, as amended, effective for periods beginning after June 15, 2021. Lessees will be required to recognize right-of-use assets and lease liabilities in the statement of net position for all leases. *PPC's Guide to Audits of Local Governments* and *PPC's Guide to Preparing Government Financial Statements* discuss the new accounting guidance.

All of the considerations listed above are relevant to the adoption of the new accounting guidance on leases. Discussions with management are particularly important in advance of adoption. Additional time and personnel may be required to locate, analyze, and gather information on existing or expired contracts that involve capital assets. Additional training or use of consultants may also be advisable to enhance accounting knowledge and capabilities. Also, the addition of former operating leases to capital assets may change the materiality benchmark, key performance indicators and ratios, and analytical procedures.

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 240B.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 240B.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 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 standard further classifies the illustrative risk factors 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 the standard.

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. One of the primary fraud risks in governmental units is fraudulent cash disbursements, in which case there is always an asset subject to misappropriation. 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 governmental unit, including disregard for established 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.

If fraud risks are present, in accordance with AU-C 330B, AU-C 240B.28, and AU-C 240B.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.

6. Which of the following is a characteristic of governmental units that may affect the audit approach?

   a. Governmental units are typically motivated to turn a profit.

   b. Financial position statement account balances are typically large.

   c. The public is very interested in fraud involving governmental resources.

   d. Typically, material grants are awarded to governmental units without restrictions.

7. A governmental unit is at higher risk of material misstatement if which of the following is true?

   a. Its investments occur in an established market.

   b. Its inventory is exclusively made up of items used during regular operations.

   c. Its net position is calculated without restrictions.

   d. It depreciates capital assets with long useful lives.

8. Which of the following governmental employees would be most likely to misappropriate government assets?

   a. Harry just reached his tenth anniversary in his department.

   b. Cho receives a promotion during the financial reporting period.

   c. Ron had to choose between taking unpaid leave or a salary reduction.

   d. Lavender loves her department and gets along well with her boss.

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.)**

6. Which of the following is a characteristic of governmental units that may affect the audit approach? **(Page 38)**

   a. Governmental units are typically motivated to turn a profit. [This answer is incorrect. One characteristic of governmental units that has an overriding influence on audit approach is the *lack* of a profit motive and the corresponding expected relationship between revenues and expenses.]

   b. Financial position statement account balances are typically large. [This answer is incorrect. A characteristic that auditors need to understand about governmental units is that many financial position statement account balances are relatively *small* dollar amounts in comparison to the level of revenues and expenses in an annual period.]

   c. **The public is very interested in fraud involving governmental resources. [This answer is correct. Because governmental units have many unique characteristics, auditors need to consider those characteristics when planning their audit approach. One such characteristic is that there is a high public interest and reaction to fraud, waste, and abuse involving government resources. This and other characteristics of governmental units mean that, compared to a nonpublic company audit, a governmental audit will have a more focused consideration on compliance with laws and regulations, a greater emphasis on transaction testing, and more concern with internal control.]**

   d. Typically, material grants are awarded to governmental units without restrictions. [This answer is incorrect. Governmental entities often have material grants with significant restrictions, which auditors will need to take into account. *Government Auditing Standards* (the Yellow Book) requires auditors to design their audits to provide reasonable assurance of detecting noncompliance with the contracts or grant agreements that could have a material effect on the financial statements.]

7. A governmental unit is at higher risk of material misstatement if which of the following is true? **(Page 43)**

   a. Its investments occur in an established market. [This answer is incorrect. According to SLG, Paragraph 4.138, Appendix A-11, one area of risk for a governmental unit is investment valuation when there is *no* market-established fair value.]

   b. Its inventory is exclusively made up of items used during regular operations. [This answer is incorrect. Per SLG, Paragraph 4.138, Appendix A-11, the governmental unit is at risk if excessive or obsolete supplies are involved with its inventory valuation.]

   c. Its net position is calculated without restrictions. [This answer is incorrect. One of the indications of risk for a governmental unit outlined in SLG, Paragraph 4.138, Appendix A-11, is the *existence* of restrictions on net position.]

   d. **It depreciates capital assets with long useful lives. [This answer is correct. SLG, Paragraph 4.138, Appendix A-11, provides examples of areas of risk of material misstatement for a governmental unit. One of the examples of higher risk is when there is depreciation on capital assets, where applicable, especially those with long useful lives.]**

8. Which of the following governmental employees would be most likely to misappropriate government assets? **(Page 48)**

   a. Harry just reached his tenth anniversary in his department. [This answer is incorrect. Anticipated layoffs that are known to employees is one fraud risk factor. Stability like Harry has, however, would not specifically indicate a risk of fraud.]

b. Cho receives a promotion during the financial reporting period. [This answer is incorrect. The failure to receive promotions or other expected rewards is a fraud risk factor. Because Cho was recently promoted, she does not fall into this specific risk factor.]

c. **Ron had to choose between taking unpaid leave or a salary reduction. [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. An example of circumstances that may indicate possible fraud risk is unfavorable changes in employee compensation or benefit plans. The auditor should consider these circumstances when auditing Ron's employer and identifying risks of material misstatement due to fraud.]**

d. Lavender loves her department and gets along well with her boss. [This answer is incorrect. Having abusive or overbearing management coupled with unreasonable expectations is an example of a situation that could lead to fraud or misappropriation of governmental assets. Because Lavender is content and comfortable in her department, she is not a red flag under these circumstances.]

OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL

AU-C 315B.13–.25 establishes requirements for auditors related to consideration of internal control as part of an audit. They also provide guidance about how the entity's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit. This section provides an overview of the general requirements of AU-C 315B related to obtaining an understanding of internal control. Detailed guidance on evaluating the design and implementation of entity-level and activity-level controls is provided in Lesson 2.

Components of Internal Control

AU-C 315B.15–.25 requires an understanding of five interrelated components of internal control defined and described in more detail in COSO's *Internal control—Integrated Framework*, as discussed below. The five components are as follows:

- Control environment
- Risk assessment
- Information and communication
- Monitoring
- 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 315B 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 315B.A58 notes that the five components of internal control (listed above) provide a useful framework for auditors when considering different aspects of internal control. AU-C 315B.A59 indicates that auditors may use different terminology or frameworks to describe various aspects of internal control providing that the five components are addressed. As such, AU-C 315B recognizes that entities may design, implement, or maintain internal control using terms different from those five components, and AU-C 315B.A53 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.

Throughout this discussion, the authors refer to the internal control components of control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-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. The authors refer to the financial reporting system and the control activities component of internal control as "activity-level" controls.

COSO Internal Control Framework. Several internal control frameworks exist internationally, but the most widely used framework in the U.S. is COSO's *Internal Control—Integrated Framework* (the COSO framework), as revised in 2013. The five components of internal control listed above are the same five components that are defined and described in the COSO framework.

Smaller governmental entities may not have formally adopted, or even be familiar with the COSO framework, but the authors believe that auditors turn to the COSO framework as a reference and guide for understanding and evaluating internal control. For that reason, the internal control practice aids in *PPC's Guide to Audits of Local Governments* include the concepts from COSO to assist auditors in obtaining an understanding and evaluating the design and implementation of internal controls.

The COSO framework helps entities design, implement, and evaluate internal control in light of current business and regulatory environments and operations by articulating 17 principles, 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. COSO has also issued several related documents that provide tools, approaches, and examples to assist entities when designing, implementing, and assessing the 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 315B 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 GAAS does not require the use of a specific framework, but the COSO framework is widely used.

Nature of the Auditor's Understanding

AU-C 315B.13–.14 requires auditors to 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 to design the nature, timing, and extent of further audit procedures. 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 a particular control prevents, or detects and corrects, material misstatements in relevant assertions related to transactions, account balances, or disclosures.

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively detecting or correcting material misstatements. In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, it may represent a control deficiency that needs to be communicated to management and those charged with governance, as more fully described in AU-C 265B, *Communicating Internal Control Related Matters Identified in an Audit*.

It is not enough to simply determine whether a control as described or documented appears to be 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 objective. The documentation of a control procedure, however, does not demonstrate that the control is actually operating as intended. 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, an auditor uses risk assessment procedures to obtain audit evidence that the control has actually 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 complete and accurate information. Generally, the auditor uses procedures such as observation or inspection, in combination with inquiries, to verify implementation. According to AU-C 315B.14, the auditor should evaluate the design of those 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 regarding the understanding of internal control is that it be sufficient to assess the risk of material misstatement of each opinion unit's 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 develop a fairly thorough and robust knowledge of all five of the components of internal control. AU-C 315B.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.

Determining the Extent of the Understanding. The extent of the understanding of internal control that is sufficient is a matter of professional judgment. 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. Generally, the extent of the auditor's understanding and the extent of the associated 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.
- Nature of the client's operations, including its organizational structure.
- Size of the entity.
- Diversity and complexity of operations.
- Nature and complexity of systems within the organization, including the use of service organizations.
- Number of internal control systems in effect during the financial statement period.
- Nature of the governmental industry.
- Applicable legal and regulatory requirements.
- The nature of any compliance auditing requirements or special reporting 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.

Although the extent of the auditor's understanding is a matter of professional judgment, AU-C 315B provides certain specific requirements related to the understanding of internal control components, which are discussed in Lesson 2. In addition, according to AU-C 315B, the auditor should understand and evaluate the following matters:

- The design and implementation of controls, including relevant control activities, related to significant risks (AU-C 315B.30).
- 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 315B.31).
- The effect of IT on internal control, specifically how IT risks affect control activities (AU-C 315B.22).

Understanding Controls Related to Significant Risks and Risks for Which Substantive Procedures Alone Are Not Sufficient

AU-C 315B.30 indicates that the auditor's understanding of internal control should include the governmental unit's programs and controls that address risks of material misstatement that are considered *significant risks*. Fraud risks are always considered to be significant risks. Significant risks often relate to significant unusual transactions; for example, with related parties and judgmental matters, such as estimates. Also, revenue recognition issues often pose significant risks. According to AU-C 240B.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 necessary, the auditor performs additional risk assessment procedures directed at gaining an understanding of controls relating to those risks.

SLG, Paragraph 4.61, indicates that when considering the nature of the risks, a number of matters need to be considered, including whether the risk (a) relates to recent significant economic, accounting, or other developments; (b) involves significant transactions with related parties; (c) involves significant unusual transactions that are unusual or outside the normal course of business for the government or that otherwise appear to be unusual; or (d) is a risk of fraud. The auditor also considers the degree of subjectivity in the measurement of financial information, especially when there is a wide range of measurement uncertainty, and the complexity of the transactions. Significant risk areas in governmental audits might include: the valuation of derivative instruments and alternative investments; landfill and pollution remediation liability estimates; asset retirement obligations; OPEB and pension disclosures; valuation of OPEB and pension liabilities; and tax, grant, and donor restrictions.

Programs and controls addressing significant or fraud 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 significant or fraud 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 fraud risks and other 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 of (or lack of) these programs and controls might either mitigate or increase the risks of material misstatement. The auditor considers 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 315B.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.

Effect of Information Technology (IT) on Internal Control

AU-C 315B indicates that auditors should consider how IT affects an entity's control activities. The effects can be extensive, but the effect on 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 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 315B.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. Such controls not only include properly designed and implemented application controls, but 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 to assess the risks of material misstatement. The auditor tests general controls when he or she plans 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 impact 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 the transaction. For example, in highly automated processing with little or no manual intervention when information is initiated, authorized, recorded, processed, or reported electronically, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.

Exhibit 1-6 provides examples of 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, the authors consider 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 governmental units. Lesson 2 discusses those effects in more detail and explains how they affect the auditor's procedures.

Exhibit 1-6

Examples of IT Aspects of Internal Control

Control Environment

1. Involvement of management in designing and approving the financial reporting system, including software coding.
2. Involvement of management in authorizing transactions and approving changes to software coding or data.
3. Involvement of management 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 300B.A20 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 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 300B.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, including having sufficient knowledge to do the following:

- Communicate with the IT professional on the objectives of his or her work.
- Evaluate whether the IT professional's specified procedures will meet audit objectives.
- Evaluate the results of the IT professional's procedures as those results relate to the nature, timing, and extent of further planned audit procedures.

To effectively perform these steps and supervise an IT specialist, auditors need a basic understanding of computer 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.

The authors believe there may be circumstances when the IT specialist will be considered an auditor's specialist rather than a member of the engagement team. These circumstances would include situations in which the IT specialist is performing procedures that are so technical and specialized that they exceed a basic understanding of computer applications and controls. In those cases, the auditor also needs to follow the requirements of AU-C 620B, *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.

Government Auditing Standards Requirements. When specialists are used on Yellow Book audits, the auditor has additional matters to consider. Those matters relate to independence, technical knowledge, and continuing professional education.

Using the Results of the Understanding

As previously noted, 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.

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. The evaluation of the design and implementation of controls may identify previously unrecognized risks of material misstatement and result in modifying the preliminary assessment of inherent risk for a relevant assertion. Identified risks should be documented. Considering the results of the understanding of controls in relation to the assessment of the risk of material misstatement of the financial statements (that is, making the control risk assessment) is outside the scope of this course, but more information can be found in *PPC's Guide to Audits of Local Governments*.

Normally, the auditor's understanding of internal control design and implementation may not be sufficient to reach a conclusion about the operating effectiveness of controls. Although the same types of procedures performed to determine if a control has been implemented (e.g., observation, inspection of documents, reperformance, and walkthroughs) may also be used when testing controls, the extent of the procedures to determine implementation may fall short of what is needed to determine operating effectiveness because they do not 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 and provide a valid basis for assessing control risk at less than high. For example, 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 governmental unit's controls relevant to cybersecurity, the auditor should follow the requirements of AU-C 265B, *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 levels to assess and respond to the risks.
- The steps management has taken to monitor the effectiveness of those controls.
- The internal process 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 governmental unit creates, uses, and stores?
- Are the control policies and procedures at both the entity and activity levels sufficient to safeguard the integrity of this data?
- How would a cyber attack affect the reliability of the governmental unit's financial reporting or result in a material loss or impairment of the governmental unit's assets?

A Practical Approach for Obtaining an Understanding of Internal Control

The key matters that affect the auditor's application of professional judgment in developing an approach for understanding internal control are whether:

- The understanding of the five components of internal control is sufficient to (a) assess the risk of material misstatement of the financial statements and (b) design the nature, timing, and extent of further audit procedures.
- The understanding is 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 understanding of the financial reporting system is sufficient to understand (a) classes of transactions that are significant; (b) the procedures 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 and disclosure information 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 understanding is sufficient to 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).

AU-C 315.19, as amended by SAS No. 134, indicates that an auditor's understanding of the information system relevant to financial reporting should include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers. An auditor's understanding has to include both the quantitative and qualitative aspects of such disclosures to identify risks of material misstatement. Qualitative disclosure information may be more likely to come from outside the general and subsidiary ledgers, which may affect both the level of assessed risks and the nature, timing, and extent of audit procedures to address them.

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. The auditor does not need to obtain an in-depth understanding of every control that relates to financial reporting but has to be sufficient to achieve a proper design of the nature, timing, and extent of further audit procedures.

The authors have developed a practical 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 the authors believe will result in an efficient and effective approach include:

- Develop an overall strategy for understanding internal control.
- Perform scoping activities.
- Evaluate the design and implementation of entity-level controls [i.e., 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. The audit plan should include a description of the nature and extent of risk assessment procedures (AU-C 300B.09). 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 reducing 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 and multiple locations.
- 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 internal controls may include the following:

- *Previous Experience with the Client.* If the engagement is new, the audit effort 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 inquires about changes in transaction types, specific controls, 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 Governmental Industry.* Based on the nature of transactions and the characteristics of the governmental industry, the auditor may expect controls to be more extensive or robust. Also, the auditor may expect additional controls to be in place that address risks associated with legal and regulatory requirements.

- *General Size, Complexity, and Sophistication of the Client.* For smaller 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 may 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. 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) significant classes of transactions; (b) the initiation, authorization, recording, processing, and reporting of 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.

- *The Extent of Use and Diversity of IT Systems.* The extent of IT used generally affects the auditor's approach to the understanding of internal control and the conduct of risk assessment procedures. To the extent that automated controls are used, there is an increased likelihood that the auditor will need a more in-depth understanding of general controls. An auditor considers 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, also helps the auditor with the decision about whether to use IT specialists for obtaining the understanding, including the understanding of general controls.

- *Identified Risks.* 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 by the risk assessment standards 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 internal control. 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), but client documentation of controls often significantly aids the efficiency of the understanding and evaluation of the design of controls and generally reduces the effort in meeting audit documentation requirements. 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.

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. These activities do not need to be overly detailed or complicated. 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. The auditor's scoping activities can be effectively accomplished by using the "top-down approach."

<u>The Top-down Approach.</u> The "top-down" strategy, or approach, to understanding internal control begins at the financial statement level and works down to the individual control activity 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. The top-down approach with respect to the understanding of entity-level controls is discussed later in this section.

- Gain an understanding of the overall risks of material misstatement at the financial statement level.
- Identify the material account balance, classes of transactions, and related disclosures that are significant to the financial statements and the related relevant assertions.
- 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 account balances, transaction classes, 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. In addition to considering planning materiality, the auditor 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, both the quantitative and qualitative aspects of disclosures, and similar factors. For example, an accounts payable balance may not be significant based on a consideration of quantitative aspects of materiality, but the risk of material misstatement due to unrecorded liabilities might justify considering it material. Identifying relevant assertions for material reported amounts 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 315B.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, and reporting those transactions. Significant transaction classes are those classes of transactions that are significant to the financial statements, generally because of the volume or risk characteristics of transactions processed. The scope of the risk assessment procedures includes obtaining an understanding of the flow of transactions for all significant transaction classes.

AU-C 315.19, as amended by SAS No. 134, indicates that an auditor's understanding of the information system relevant to financial reporting should include relevant aspects of the system related to information disclosed in the financial statements obtained from within or outside of the general and subsidiary ledgers. Disclosure information from outside of the general and subsidiary ledgers may include lease and other significant agreements and fair value information from a specialist engaged by management. AU-C 315.A99, as amended by SAS No. 134, observes that aspects of the system relevant to disclosure information for smaller, less complex entities are likely to be less sophisticated than for larger entities, but are just as significant.

Evaluate the Design and Implementation of Entity-level Controls. Auditors may be tempted to focus first on the information system and related control activities because they are directly related to the assertions that are relevant to the financial statements. However, they should normally obtain 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—because entity-levels controls may have a pervasive effect on other controls; they 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.

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. 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.

Evaluate the Design and Implementation of Activity-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. Because both quantitative and qualitative aspects of disclosure information may be obtained from outside of the general and subsidiary ledgers, additional attention to control activities related to gathering this information may be necessary.

Documentation

AU-C 315B.33 requires documentation of the understanding of the entity and its environment, including internal control. The auditor is required to document the understanding obtained for each of the five components of internal control. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding. One method to assist with documentation is to use practice aids, such as those provided in *PPC's Guide to Audits of Local Governments*.

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 capital assets additions are correctly recorded," might be a control objective that addresses a risk of capital asset transactions not being properly tracked and recorded (i.e., completeness). Failure to achieve that control objective could potentially result in overstatement or understatement of capital assets and depreciation expense, as well as misstatements in other income statement accounts.

The term *control objectives* in this course is used in connection with controls relating to the account balance, transaction class, or disclosures, as well as general IT controls. For entity-level controls, such as control environment and monitoring controls, this course refers to *principles* instead of control objectives. As noted earlier in this section, these principles are adapted from the COSO 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 in a few words and that give direction to implementation. For example, within the component of the control environment, the principle, "the entity demonstrates a commitment to integrity and ethical values," provides understanding of the goal to be achieved. (Exhibit 2-1 provides a listing of principles for the control environment.)

Similar to control objectives, if a principle is not present and functioning at the entity, 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.

Key Controls. As indicated at AU-C 315B.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 objective. When identifying controls, evaluating design effectiveness, determining implementation, and, if applicable, testing controls, it is often more 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 considers factors such as:

- The nature of the risks being addressed.
- The characteristics of related account balances, transaction classes, and disclosures.
- 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 more likely arise from error, fraudulent financial reporting, or misappropriation of assets?).

SELF-STUDY QUIZ

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

9. Which of the following statements best describes an aspect of the auditor's understanding of internal control?

   a. The extent of the auditor's understanding is a matter of professional judgment.

   b. The professional standards pose no requirements for the understanding.

   c. The auditor should address all risks equally when obtaining this understanding.

   d. The auditor should focus on the control activities element of internal control.

10. The auditor must do which of the following when using an IT specialist?

    a. Be an IT expert so as to check the specialist's work.

    b. Have a basic understanding of computer applications and controls.

    c. Designate the IT specialist as an auditor's specialist.

    d. Choose someone from inside the auditor's firm.

11. When would an auditor perform scoping activities while obtaining an understanding of internal control?

    a. After developing an overall strategy.

    b. After obtaining an understanding of activity-level controls.

    c. Prior to accepting the engagement.

    d. When detailed and complicated procedures are needed.

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.)**

9. Which of the following statements best describes an aspect of the auditor's understanding of internal control? **(Page 56)**

   a. **The extent of the auditor's understanding is a matter of professional judgment. [This answer is correct. The extent of the understanding of internal control that is sufficient is a matter of professional judgment. The auditor is not required to obtain an understanding and evaluation of all 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.]**

   b. The professional standards pose no requirements for the understanding. [This answer is incorrect. AU-C 315B provides certain specific requirements related to the understanding of internal control components. It also indicates that the auditor should understand and evaluate (1) the design and implementation of controls, including relevant control activities, related to significant risks; (2) controls over risks for which substantive procedures alone are not sufficient; and (3) the effect of IT on internal control, specifically how IT risks affect control activities.]

   c. The auditor should address all risks equally when obtaining this understanding. [This answer is incorrect. AU-C 315B.30 indicates that the auditor's understanding of internal control should include the governmental unit's programs and controls that address risks of material misstatement that are considered *significant risks*. Fraud risks are always considered significant risks. Significant risks also often relate to significant unusual transactions and revenue recognition issues.]

   d. The auditor should focus on the control activities element of internal control. [This answer is incorrect. Programs and controls addressing significant or fraud risks may relate to any of the five elements of internal control; thus, the auditor needs to use care *not* to isolate the understanding to only the control activities component.]

10. The auditor must do which of the following when using an IT specialist? **(Page 59)**

   a. Be an IT expert so as to check the specialist's work. [This answer is incorrect. According to AU-C 300B.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.]

   b. **Have a basic understanding of computer applications and controls. [This answer is correct. To effectively perform the steps outlined in the AICPA Risk Assessment Guide and supervise an IT specialist, auditors need a basic understanding of computer 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 and seminars.]**

   c. Designate the IT specialist as an auditor's specialist. [This answer is incorrect. There may be circumstances when the IT specialist will be considered an auditor's specialist, such as situations in which the IT specialist is performing procedures that are so technical and specialized that they exceed the auditor's understanding of information technology. However, when that is not the case, the IT specialist can be considered part of the engagement team.]

   d. Choose someone from inside the auditor's firm. [This answer is incorrect. An IT specialist may be either a member of the auditor's firm or an outside professional. The auditor is not required to use only in-firm IT specialists.]

11. When would an auditor perform scoping activities while obtaining an understanding of internal control? **(Page 64)**

    a. **After developing an overall strategy. [This answer is correct. 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.]**

    b. After obtaining an understanding of activity-level controls. [This answer is incorrect. Based on the approach outlined in this course, obtaining an understanding of activity-level controls is one of the later steps in the process. Therefore, scoping activities would need to be completed first.]

    c. Prior to accepting the engagement. [This answer is incorrect. Engagement acceptance procedures are considered preliminary procedures. They would be performed before the auditor begins obtaining an understanding of the entity, its environment, and its internal control.]

    d. When detailed and complicated procedures are needed. [This answer is incorrect. Scoping activities do *not* need to be overly detailed or complicated. They can be effectively accomplished by using a "top-down approach."]

Lesson 2: Understanding Entity-level and Activity-level Controls, Planning Decisions and Judgments, Fraud, Noncompliance with Laws and Regulations, and the Audit Time Estimate

INTRODUCTION

Lesson 2 continues the discussion of risk assessment procedures and planning in a governmental audit engagement. It covers the following topics:

- Obtaining an understanding of entity-level controls, including the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring, as well as the IT environment and general IT controls.
- Obtaining an understanding of activity-level controls, including the financial reporting system, and control activities.
- 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.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine what an auditor should do to obtain an understanding of a governmental unit's entity-level and activity-level controls.
- Identify the planning decisions and judgments that an auditor may have to make in a governmental audit.
- Recognize how an auditor should address fraud and compliance with laws and regulations during a governmental audit and how to plan a time-efficient audit.

ENTITY-LEVEL CONTROLS

The authors refer to the internal control components of the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-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 through the understanding of entity-level controls. As a result, the authors recommend that auditors 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 315B.A80, the elements of the control environment that may be relevant when understanding the control environment include the following:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation of those charged with governance.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.

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 governing board members, if any, who are expected to understand the entity's 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 ensure 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.

COSO Principles for Risk Assessment. 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. These COSO principles, shown in Exhibit 2-1, incorporate the control environment elements discussed above.

Exhibit 2-1

Control Environment—COSO Principles

- The entity demonstrates a commitment to integrity and ethical values.
- The governing body demonstrates independence from management in exercising oversight of the development and performance of internal control over financial reporting (and, if applicable, its compliance with federal statutes, regulations, and the terms and conditions of federal awards).
- With governing body oversight, management establishes structures, reporting lines, and appropriate authorities and responsibilities to achieve financial reporting objectives (and, if applicable, compliance objectives relative to major programs).
- The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with financial reporting objectives (and, if applicable, compliance objectives relative to major programs).
- The entity holds individuals accountable for their internal control responsibilities (and, if applicable, compliance objectives relative to major programs).

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 governmental unit.

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 for a policy to be in place and operating effectively. For example, in a small governmental unit, all of the human resource policies may not be formally documented. Even so, policies and practices can still exist and be communicated orally. When documentary evidence is not available, the auditor might observe management's 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 2-2 provides examples of possible risk assessment procedures that could be used when evaluating the design and implementation of the control environment.

Exhibit 2-2

Examples of Risk Assessment Procedures for Evaluating Design and Implementation—Control Environment

Illustrative Risk Assessment Procedures	
Evaluating Design	**Determining Implementation**
• 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 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.
• 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.

Illustrative Risk Assessment Procedures	
Evaluating Design	**Determining Implementation**
• 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 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 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.

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 financial statement 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 in Lesson 1, 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 pervasive 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 entity having robust risk assessment, information and communication, monitoring, and control activities are significantly reduced. 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.

Documentation of the Control Environment. The auditor's understanding of the control environment, along with the sources of information and procedures performed to obtain or update the understanding, should be documented. One method for doing so is by using the practice aids provided in *PPC's Guide to Audits of Local Governments*.

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 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 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 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 operating approaches or activities.

g. Restructurings.

h. New accounting standards.

AU-C 315B.17–.18 requires the auditor to obtain an understanding of 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 it failed and whether the process is appropriate in the circumstances or contains a significant deficiency or material weakness. If the entity does not have 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 315B.16–.18 is not the same as an auditor's consideration of risk in a financial statement audit. The auditor assesses risks of material misstatement at the financial statement level and the assertion level. At the assertion level, the auditor assesses inherent risk and control risk to evaluate the likelihood of a material misstatement in an account balance, class of transactions, or disclosure. 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, the authors believe management's risk assessment process, as it relates to financial reporting, has some similarities to the auditor's assessment of 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.

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. The fraud risk assessment and monitoring process for a typical governmental unit may include:

a. Communicating to employees management's views on operating 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 operating 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. Appropriate oversight of the entity's fraud risk assessment and monitoring activities by the audit committee or similar group.

Principles. 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 principles for risk assessment are shown in Exhibit 2-3.

Exhibit 2-3

Risk Assessment—COSO Principles

- The entity specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to financial reporting objectives (and, if applicable, compliance objectives relative to major programs).
- The entity identifies risks to achieving its objectives (including, if applicable, compliance objectives relative to major programs) 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 (and, if applicable, compliance objectives relative to major programs).
- The entity identifies and assesses changes that could significantly impact the system of internal control (and, if applicable, its compliance with federal statutes, regulations, and the terms and conditions of federal awards).

Risk Assessment Procedures and Factors to Consider. 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 how management approaches operating risks, including those that are specifically relevant to financial reporting. However, the process for assessing risk in smaller governmental units usually is informal with little or no documentation. The internal control objectives may be recognized implicitly rather than explicitly. Management can learn about risks affecting those objectives through direct personal contact with employees and external parties. This 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.

As a result, the auditor can tailor risk assessment procedures based on factors such as the size and complexity of the entity. The authors believe, however, that in most situations, documented evidence of the entity's risk assessment process will be minimal and the auditor will rely more heavily on inquires of management about how risks are identified and addressed. For most small and midsize governmental units, 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. Specifically, if the events or circumstances listed earlier (changes in operations, new personnel, new or revised information systems, etc.) 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.

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.

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.

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 regarding 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 since the auditor gains knowledge of the types, sources, and locations of documents and other evidence along with the individuals who are responsible for processing them. 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.

Information. 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 the information technology is used in those applications, and the relative complexity and importance of use of the IT. The auditor also considers the qualifications of accounting personnel and the time pressure they face. 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.

The risk assessment 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 in the next section of this lesson.

Principles for Information. 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 (and, if applicable, to compliance with major federal award program requirements).

Risk Assessment Procedures and Factors to Consider. For most small and midsize governmental units, 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. The auditor's risk assessment procedures related to the financial reporting system at the account balance, transaction class, and disclosure level are discussed in the next section.

Communication. The auditor needs to obtain a sufficient understanding of how management communicates financial reporting roles and responsibilities and other significant matters related to financial reporting. 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. For upstream communication to occur, there need 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 a governmental unit 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.
- 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).

Principles for Communication. 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 2-4.

Exhibit 2-4

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 (and, if applicable, to compliance with major federal award program requirements).
- The entity communicates with external parties regarding matters affecting the functioning of internal control (and, if applicable, to compliance with major federal award program requirements).

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 about 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 (or summaries of recent meetings for which minutes have not yet been prepared) regarding the communication between management and those charged with governance.
- Inquire of employees about how upstream financial communication is received and implemented by management.
- Review of whistleblower policies and inspection of documentation regarding reported instances of suspected financial improprieties.

- Inquiry and review of related documentation of how communication from external parties is processed.

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.

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. 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.

Principles for Monitoring. 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 2-5.

Exhibit 2-5

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 governing body, as appropriate.

Monitoring Activities. According to AU-C 315B.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 315B.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 of enterprise funds.
- Review of a reporting system that tracks timely collection efforts.
- Analysis of reported disbursement errors.
- Legal department review of compliance with ethics policies.

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 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 senior official to evidence his 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.

Consideration of Internal Audit Function. One method some entities use to monitor internal control is through separate evaluations by the internal audit function. If there is a designated internal audit function, the auditor should obtain an understanding of that function during audit planning. AU-C 315B.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. *PPC's Guide to Audits of Nonpublic Companies* provides a discussion of the requirements of AU-C 610B related to determining whether and to what extent the auditor may use the work of the internal audit function or use internal auditors to provide direct assistance to obtain evidence that the monitoring component is present and functioning.

In addition, AU-C 240B and AU-C 315B 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 240B.19, as amended by SAS No. 135, 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, whether they have knowledge of any actual or suspected fraud, and whether the entity has entered into any significant unusual transactions. 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.

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 governmental units have simple IT operations. Typically, they use PCs, which may be linked in a local area network (LAN), and use purchased software packages for specific applications, such as accounts receivable. However, some entities may have internal control that is heavily dependent on information technology.

An entity with a simple IT system may use primarily paper-based manual procedures. It 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 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 of the government's 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. For example, in a system in which 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.

When obtaining an understanding of the IT environment, auditors consider how procedures are performed and what data is stored. As part of understanding 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, a data processing bureau provides payroll services, or a 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 computer system.

General IT Controls. AU-C 315B.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 general IT controls and determines whether they have been implemented to assess 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 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 prepackaged 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 prepackaged applications; systems and data back-up and recovery procedures; and controls over the creation, use, and maintenance of critical spreadsheet applications.

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, 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. One method for doing so is by using practice aids such as those provided in *PPC's Guide to Audits of Local Governments*.

ACTIVITY-LEVEL CONTROLS

The authors refer 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.

Controls throughout the system may be either manual or automated and may be significantly affected by IT. Therefore, the auditor should also obtain an understanding of the entity's IT environment and general IT 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.

The subjects discussed in this section include the audit procedures used to obtain an understanding of the financial reporting system, the typical extent of that understanding that is required, and the circumstances when a more extensive understanding may be necessary. Throughout the process of obtaining an understanding of activity-level controls, the auditor should be aware of the requirements to obtain an understanding of:

- Controls related to significant or fraud risks.
- Controls related to risks for which substantive procedures alone are not adequate.
- 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 later in this section.

Financial Reporting System

The financial reporting system includes the procedures and records established to initiate, authorize, record, process, correct, transfer to the general ledger, and report the entity's transactions as well as the accountability over assets, liabilities, and equity. The auditor often spends a significant amount of 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, 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 315B.19 states that the auditor should obtain sufficient knowledge of the financial reporting system, including related processes, to understand the following:

a. *Classes of Transactions.* The classes of transactions in the entity's operations that are significant to the financial statements.

b. *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.

c. *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.

d. *Other Events and Conditions.* The methods used to capture significant events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include asset impairment, commitments and contingencies, subsequent events, compliance with debt covenants, related party transactions, going concern uncertainties, and fair values of financial instruments.

e. *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.

f. *Journal Entries.* The controls over standard and nonstandard journal entries.

Auditors need to be satisfied that they have a sufficient understanding of the financial reporting system to understand how misstatements might occur anywhere in the cycle from the occurrence of transactions to the final presentation in the financial statements. In a simple financial reporting system, when the auditor assists with the preparation of financial statements and disclosures, the authors believe understanding the financial reporting system generally will involve:

- Understanding the financial close and reporting process.
- Identifying the entity's significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.

Understanding the Financial Close and Reporting Process. Events and conditions other than transaction classes (that is, other than items processed through the entity's transaction processing systems) are often material to the preparation of financial statements. Examples include accruals for contingencies, commitments, and related party transactions. 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 from sources other than the entity's 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 that require 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.

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 unusual transactions outside the normal course of business.
- Develop and evaluate significant accounting estimates (for example, OPEB, impairment of long-lived assets, and accrued loss contingencies).
- 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 (a) adequately describe the accounting policies to be followed, (b) address disclosures needed to comply with GAAP, (c) provide a means of identifying inter-entity balances and transactions, and (d) require approval of financial information by component management.
- Combine and consolidate general ledger data.
- Prepare, review, and approve the financial statements and disclosures, including procedures used to prepare the government-wide financial statements and related reconciliations.

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 these 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.

Understanding the Flow of Information for Significant Transaction Classes. When obtaining an understanding of the flow of information through the entity's financial reporting system, 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 are used or created when processing transactions?

   (3) What subsidiary journals or ledgers are involved?

   (4) 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 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 by the entity. That is a specific requirement of AU-C 315B.19. Some systems use suspense accounts or files to capture failed transactions. For such situations, the auditor would need to 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 315B.21 requires the auditor to understand the process for reconciling the detail records to the related general ledger accounts. While reconciling procedures are technically a control activity, the understanding is typically obtained when developing a knowledge of the flow of transactions.

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 nature and extent of the auditor's 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, should be performed to ensure that the system has been implemented as designed.

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" 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 relevant controls.

Walkthroughs of transactions include document inspection and 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 initial creation of a source document to final posting in the general ledger. 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(s) or control(s).
- 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 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 a selected 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. When one broad class of transactions includes different types of transactions that are initiated, authorized, processed, or recorded differently, use different documents, or involve different categories of personnel, at least one of each type ought to be selected for a walkthrough. For example, for acquisition of investments, if the process for a particular type of security differs from other securities in who may authorize acquisition, safekeeping arrangements, and monitoring, a separate walkthrough ought to be performed. The authors believe that transactions that differ in key aspects of processing and documentation are a separate major class of transactions. Regardless of whether such transactions are defined as a major class of transactions or a significantly different type of transaction within a major class, there is a need for a separate walkthrough. A walkthrough is a powerful tool to provide assurance that the auditor understands the category of transactions and the related controls and ought to be viewed as more than a simple compliance procedure.

How Often to Perform Walkthroughs? A nonauthoritative AICPA Technical Question and Answer, *Use of Walkthroughs* (Q&A 8200.12), discusses performing walkthroughs. As previously noted, 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 might perform walkthroughs every year for significant accounting cycles. Even though, as explained in Lesson 1, AU-C 315B 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 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 the prior period's 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 control environment, management's risk assessment process, monitoring, and general controls.
- Reliance on automation.
- Changes in circumstances, such as changes in the client's personnel, business practices, operations, etc.
- Risks of material misstatement for the relevant assertion.
- Length of time since prior performance of extensive risk assessment procedures (time elapsed since 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.

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 315B.21 requires the auditor to obtain an understanding of control activities relevant to the audit and explains that they are those that "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 315B.A166 provides examples of categories of control activities that are relevant to the audit are described as follows:

- *Performance Reviews.* Performance reviews are comparisons of current financial reports to other information.
- *Information Processing.* Controls that are performed to check accuracy, completeness, and authorization of transactions. For information systems, there are two broad categories of control activities—application controls and general controls.
- *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.* This relates to the assignment of different people to authorize transactions, record transactions, and maintain custody of assets.
- *Accountability.* Controls that pertain 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.

<u>Control Activities Always Relevant to the Audit.</u> 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.

<u>Control Activities That May Be Relevant to the Audit.</u> 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 2-6.

Exhibit 2-6

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.

Obtaining an Understanding of Control Activities. The auditor first considers knowledge about control activities obtained through the understanding of other components of internal control 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. Most frequently, the auditor learns of control activities while obtaining an understanding of the financial reporting process. 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. 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 are more likely to occur. The auditor's evaluation will generally be focused on significant transaction classes and accounts. Auditors should consider that information relating to financial statement disclosures may be obtained from within or outside of the entity's general and subsidiary ledgers, and use professional judgment in determining the necessary understanding of relevant aspects of the information system(s) involved. Furthermore, 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.
- 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 selected transaction classes, account balances or disclosures at the assertion level. 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, transaction classes or disclosures. 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.

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 governmental unit and its 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 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, a further understanding of control activities may be necessary when the client depends heavily on the computer 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, a further understanding of general, application, and user computer 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.

If the auditor considers it necessary to obtain an additional understanding of control activities or decides he or she does not have a sufficient understanding to assess the risks of material misstatement and develop appropriate responses, the auditor should apply additional risk assessment procedures to understand the relevant control activities (if any) and evaluate their design and implementation. When determining risk assessment procedures that may be used to identify control activities, consider the discussion beginning in the "Risk Assessment Procedures" paragraph earlier in this section. Furthermore, the auditor may consider applying walkthrough procedures to confirm the understanding.

Documenting Activity-level Controls

Activity-level controls should be documented. One method for doing so is by using the practice aids provided in *PPC's Guide to Audits of Local Governments*. Those practice aids can help users document the financial reporting system, walkthroughs, and control activities.

SELF-STUDY QUIZ

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

12. The auditor's consideration of changes that may impact internal control is typically a part of which of the following?
    a. Control environment.
    b. Communication.
    c. Monitoring.
    d. Risk assessment.
13. Which of the following statements most accurately describes an aspect of one of the elements of control associated with entity-level activities?
    a. All governmental units are required to have a risk assessment process that is formally documented.
    b. Communication is one method management can use to convey the tone at the top of the governmental unit.
    c. For audits of governmental units, auditors should focus on the financial reporting system instead of on the unit's communication.
    d. Governmental auditors should avoid close consideration of any internal audit function so they do not corrupt their own work.
14. Data center and network operations are an example of which of the following?
    a. Activity-level controls.
    b. Control activities.
    c. General controls.
    d. Key controls.
15. What is a *walkthrough*?
    a. A method for identifying significant transaction classes.
    b. A procedure in which a transaction is traced from initiation to conclusion.
    c. A method for determining whether control activities are relevant to the audit.
    d. A process for documenting an entity's activity-level controls.
16. Which of the following matters addressed by control activities is **not** always relevant to the audit?
    a. Significant risks.
    b. Fraud risks.
    c. Risks that can be supported by substantive procedures alone.
    d. Risks related to recording nonstandard, unusual journal entries.

17. Which of the following guidance applies when an additional understanding of control activities is deemed necessary?

    a. Management determines when such an additional understanding will be necessary.

    b. The determination is typically focused on significant transaction classes and accounts.

    c. Internal control questionnaires should be filled out for all material account balances, transaction classes, and disclosures.

    d. The knowledge gained when obtaining an understanding of the other four elements of internal control will be sufficient.

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.)**

12. The auditor's consideration of changes that may impact internal control is typically a part of which of the following? **(Page 75)**

    a. Control environment. [This answer is incorrect. According to AU-C 315B.A80, the elements of the control environment that may be relevant when understanding the control environment include (1) communication and enforcement of integrity and ethical values, (2) commitment to competence, (3) participation of those charged with governance, (4) management's philosophy and operating style, (5) organizational structure, (6) assignment of authority and responsibility, and (7) human resource policies and procedures. The consideration described above is associated with a different element of internal control.]

    b. Communication. [This answer is incorrect. For the communication part of the information and communication element of internal control, the auditor needs to obtain a sufficient understanding of how management communicates financial reporting roles and responsibilities and other significant matters related to financial reporting. Auditors consider both (1) the aspects of the communication process that help ensure employees and those charged with governance understand their jobs and responsibilities within the financial reporting system and are encouraged to report any exceptions, and (2) any areas where communication does not occur. The consideration outlined above is typically associated with a different element of internal control.]

    c. Monitoring. [This answer is incorrect. The elements of an entity's monitoring process include (1) ongoing and/or separate evaluations and (2) evaluation and reporting of internal control deficiencies. The actions described above are taken in relation to a different element of internal control.]

    d. **Risk assessment. [This answer is correct. Risk assessment is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives. An entity's risk assessment process generally includes (1) financial reporting objectives, (2) management of financial reporting risks, (3) consideration of fraud risk, and (4) consideration of changes that could impact internal control.]**

13. Which of the following statements most accurately describes an aspect of one of the elements of control associated with entity-level activities? **(Page 78)**

    a. All governmental units are required to have a risk assessment process that is formally documented. [This answer is incorrect. 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 how management approaches operating risks, including those that are specifically relevant to financial reporting. However, the process for assessing risk in smaller governmental units usually is informal with little or no documentation. The internal control objectives may be recognized implicitly rather than explicitly.]

    b. **Communication is one method management can use to convey the tone at the top of the governmental unit. [This answer is correct. Communication is one way that management conveys 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.]**

    c. For audits of governmental units, auditors should focus on the financial reporting system instead of on the unit's communication. [This answer is incorrect. 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 regarding the audit. 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.]

d. Governmental auditors should avoid close consideration of any internal audit function so they do not corrupt their own work. [This answer is incorrect. One method some entities use to monitor internal control is through separate evaluations by the internal audit function. If there is a designated internal audit function, the auditor should obtain an understanding of that function during audit planning. AU-C 315B.24 indicates that if the entity (governmental or not) 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.]

14. Data center and network operations are an example of which of the following? **(Page 82)**

a. Activity-level controls. [This answer is incorrect. Activity-level controls and processes operate at the assertion level rather than at the overall financial statement level. The items above are more overarching in concept and do not fit under this term.]

b. Control activities. [This answer is incorrect. Control activities are the policies and procedures that help ensure that management directives are carried out. The items above do not fall under this classification.]

c. **General controls. [This answer is correct. General controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT controls ordinarily include controls related to (1) IT strategic planning and risk management, (2) data center and network operations, (3) physical security and access to programs and data, and (4) program changes and system acquisition and development.]**

d. Key controls. [This answer is incorrect. Key controls are those considered primary to achieving objectives. The above items might or might not be considered key controls; that is not apparent from the information supplied. However, a different term more definitely applies.]

15. What is a *walkthrough*? **(Page 87)**

a. A method for identifying significant transaction classes. [This answer is incorrect. 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 these classes. However, the process of determining when transaction classes are considered significant is not called a walkthrough.]

b. **A procedure in which a transaction is traced from initiation to conclusion. [This answer is correct. 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" 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.]**

c. A method for determining whether control activities are relevant to the audit. [This answer is incorrect. 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 the auditors' evaluation of all the particular facts and circumstances of the engagement. When answering this question for a particular audit, those publications would be a much more relevant source of information than a walkthrough.]

d. A process for documenting an entity's activity-level controls. [This answer is incorrect. Activity-level controls should be documented. Walkthroughs, however, are not performed in order to document activity-level controls. They provide other information that the auditor uses when gaining an understanding of internal control.]

16. Which of the following matters addressed by control activities is **not** always relevant to the audit? **(Page 89)**

    a. Significant risks. [This answer is incorrect. 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. Such control activities include those related to significant risks.]

    b. Fraud risks. [This answer is incorrect. As discussed in Q&A 8200.20, control activities related to fraud risks are always considered relevant to the audit.]

    c. **Risks that can be supported by substantive procedures alone. [This answer is correct. Per Q&A 8200.20, control activities related to risks for which substantive procedures alone do not provide sufficient appropriate evidence will always be relevant to the audit. This may not be the case if they can be completely supported by substantive procedures.]**

    d. Risks related to recording nonstandard, unusual journal entries. [This answer is incorrect. Control activities related to recording of journal entries including nonstandard entries that record adjustments or nonrecurring, unusual transactions are considered always relevant to the audit by Q&A 8200.20.]

17. Which of the following guidance applies when an additional understanding of control activities is deemed necessary? **(Page 90)**

    a. Management determines when such an additional understanding will be necessary. [This answer is incorrect. After considering the control activities previously identified, the *auditor* (not management) evaluates whether a sufficient understanding of control activities has been obtained for those areas where the auditor considers material misstatements are more likely to occur.]

    b. **The determination is typically focused on significant transaction classes and accounts. [This answer is correct. The evaluation of whether additional understanding of the control activities is necessary is generally focused on significant transaction classes and accounts. Information relating to financial statement disclosures may be obtained from within or outside of the entity's general and subsidiary ledgers, and professional judgment is used to determine the necessary understanding of relevant aspects of the information system(s) involved.]**

    c. Internal control questionnaires should be filled out for all material account balances, transaction classes, and disclosures. [This answer is incorrect. Even if it is concluded that additional attention to control activities is necessary, the focus can be on controls related to selected transaction classes, account balances, or disclosures at the assertion level. It is *not* necessary to complete an internal control questionnaire or prepare additional documentation to describe the control activities for all material account balances, transaction classes, or disclosures.]

    d. The knowledge gained when obtaining an understanding of the other four elements of internal control will be sufficient. [This answer is incorrect. 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.]

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 each opinion unit 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 opinion unit level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures. Risks of material misstatement at the relevant assertion level for account balances, transaction classes, and disclosures (item f.), as well as those relating to the specific nature, timing, and extent of further audit procedures (item g.), are beyond the scope of this course, but they are discussed in *PPC's Guide to Audits of Local Governments*. The other planning decisions and judgments (items a.–e.) are discussed in the following paragraphs in this section.

Determining Materiality at the Opinion Unit Level

According to AU-C 320B.10, the auditor should determine a materiality level for the financial statements as a whole when establishing the overall strategy for the audit. AU-C 320B.A4 and SLG, Paragraphs 4.72–.77, clarify that in the context of a governmental audit, the concept of materiality for the financial statements as a whole, means establishing materiality levels for each opinion unit. 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 opinion unit. The auditor uses the concept of materiality both in (a) planning and performing the audit and (b) in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the opinion unit 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 320B.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 320B.06 observes that it is not practical to design audit procedures to detect all misstatements that could be material solely because of their nature (qualitative considerations), but when evaluating the effect of uncorrected misstatements on the opinion unit 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 320B 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 320B.04, is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. AU-C 200B.07 observes that generally misstatements or omissions are viewed as material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgement made by a reasonable user based on the financial statements, and that materiality decisions involve both quantitative and qualitative considerations. AU-C 320B does not adopt or provide a specific definition of materiality. AU-C 320B.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 U.S. GAAP, for example, then the pronouncements of the GASB would provide a frame of reference for making materiality decisions and judgments.

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. These rules of thumb generally apply a percentage to a benchmark amount from the opinion unit financial statements. AU-C 320B.A6 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.
- Focus of financial statement users' attention on particular items (for evaluating financial performance).
- Nature of the entity, where it is in its life cycle, and the industry and economic environment in which it operates.
- Structure of the entity and the way it is financed.
- Relative volatility of the benchmark.

A discussion of how these factors are considered in a governmental unit audit is provided later in this section.

Determining the Benchmark. The basic notion of materiality does not change in a governmental engagement. Materiality is a concept of relative importance and is usually calculated by applying an appropriate percentage to a relevant benchmark. The matters that relate to determining a benchmark that are unique to governmental engagements are as follows:

- The level of financial statements on which the auditor has been engaged to express an opinion (i.e., the opinion unit level or a more detailed level).
- Characteristics of governmental units and governmental financial statements, in general.
- Certain items need to be excluded from the calculation of the benchmark and, instead, have a separate calculation.

Government Auditing Standards Requirements. The Yellow Book, Paragraph 6.03, explain that additional materiality considerations might apply when the audit is conducted under *Government Auditing Standards*. In Yellow Book financial audits, it may be appropriate to use lower materiality levels than in a GAAS audit because of the public accountability of governmental entities and entities receiving government funding, various legal or regulatory requirements, and the sensitivity of government programs.

Level of Financial Statements. The level of financial statements on which the auditor has been engaged to express an opinion has a significant influence on the calculation of planning materiality and the resulting scope of audit programs. Auditors can be engaged to opine on a more detailed level than what is generally required that results in a change in the normal materiality determination. However, the basic materiality determination for planning, performing, evaluating, and reporting is based on an *opinion unit* as explained in the following paragraphs. SLG, Paragraph 4.74, indicates the auditor makes separate materiality determinations for each of the following *opinion units*, if applicable:

- Governmental activities.
- Business-type activities.
- Each major governmental fund.

- Each major enterprise fund.
- Aggregate discretely presented component units.
- Aggregate remaining fund information (includes nonmajor governmental and enterprise funds, internal service fund type, and fiduciary fund types).

Each major fund is a separate opinion unit whether based on the quantitative calculation or management discretion. The auditor should consider the information in the required reconciliations from the funds financial statements to the government-wide financial statements as it relates to the presentation of the governmental activities and the business-type activities opinion units.

The two aggregate opinion units (discretely presented component units and remaining fund information) can be combined into one single opinion unit when either of the two aggregate opinion units is quantitatively and qualitatively immaterial to the primary government. The resulting combined opinion unit is called the *aggregate discretely presented component unit and remaining fund information*. No further combining or aggregations of opinion units is allowed, even though Question 7.4.1 of the GASB *Comprehensive Implementation Guide* suggests that financial statement preparers further disaggregate the remaining fund information for materiality purposes. It states that the components of the remaining fund information may or may not be quantitatively material and that the decision about materiality for those reporting units should be based on professional judgment. The decision should take into account relevant qualitative factors and the relationship of the remaining funds to other information in the financial statements. Most general purpose governments will have at least five separate opinion units—one for each of the first four bullets listed above and one combined aggregate opinion unit.

A separate materiality determination should be made for each opinion unit. According to Question 7.4.2 of the GASB *Comprehensive Implementation Guide*, materiality assessments for the reconciliations between the fund financial statements and the government-wide financial statements should be considered in conjunction with the government-wide financial statements. This is the case even though those reconciliations are presented on the fund financial statements or in schedules that accompany them.

Certain circumstances may necessitate that the auditor be engaged to audit at a more detailed level than the opinion unit used for the basic financial statements—such as at the individual fund or fund type level. However, this more-detailed audit scope would supplement rather than replace the audit of the basic financial statements based on the previously identified opinion units. SLG, at Paragraph 4.87, indicates that the auditor needs to also plan, perform, evaluate the results of, and report on the government's financial statements at the more-detailed level by establishing additional opinion units that correspond to the expanded scope.

Selecting a Benchmark. Selecting a benchmark may be considered the most important aspect of determining planning materiality because, as explained in AU-C 320B.A10, 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 320B 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 governmental unit's financial statements, based on discussions with management and those charged with governance and the auditor's experience with the governmental unit 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.

For many governmental units, using total assets or total revenue often provides a sound benchmark. Both measures are relevant because of the emphasis on financial resources in governmental accounting and financial reporting. Nevertheless, because it is unlikely that such benchmarks will adequately address user needs for the opinion units in all governmental entities, the auditor needs to identify whether there are financial statement items on which, for the particular entity and opinion unit, users' attention tends to be focused. If a financial statement item such as total cost (expenditures/expenses), total liabilities, or some other amount is more important to users than total revenue or total assets, then the auditor estimates the planning materiality amount using that financial statement element as the 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 revenues, total assets, and total cost (expenditures/expenses), 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.

Items Excluded from the Benchmark. Some auditors favor benchmarks that are not volatile and that are, thus, more stable and predictable. As noted earlier, AU-C 320B.A6 acknowledges that the relative volatility of the benchmark is a factor to consider in identification of an appropriate benchmark. Because of certain unique features of governmental accounting, some amounts included in the assets or revenues of certain opinion units may need to be adjusted. In determining *total assets* for calculation of planning materiality, the auditor excludes interfund receivables and agency fund assets. In determining *total revenue* for calculation of planning materiality, the auditor excludes interfund transfers and bond and other debt proceeds. These adjustments are intended to make the benchmark less volatile and more representative of the actual size of recurring activity.

Paragraph 4.78 of SLG indicates that auditors may choose to consider qualitative factors when determining materiality, such as whether large-dollar activity or balances may distort quantitative measures. If this is the case, auditors may choose to eliminate certain large dollar items from the calculation and set separate planning materiality levels for the excluded items and for the remaining items. For example, the governmental activities opinion unit may have significant amounts of general capital assets that are equal to or greater than total other assets of that opinion unit. In that case, the auditor might set one level of materiality for general capital asset activity and balances and another set for the opinion unit's other activities and balances. However, even if the auditor elected to use this two-tiered approach to determining materiality, a single opinion would still be rendered on each opinion unit.

Special Considerations in Selecting a Benchmark. In certain cases, the use of total assets or total revenues as a benchmark may be inappropriate because they are not relevant in the circumstances. Most capital projects funds, for example, are substantially completed at year end, and revenues are typically not significant. In this case, total assets or total project cost (expenditures) seems to be the most relevant benchmark. Some enterprise funds, such as utilities, are very capital intensive, and the use of total assets as a base results in a planning materiality amount that is disproportionately large in comparison to the fund's operations. For an enterprise fund, the primary reporting focus is often the level of operations, and total revenues or total cost (expenses) is usually the most appropriate materiality benchmark. The auditor should use professional judgment in determining the appropriate benchmark for the various opinion units. AU-C 320B.A10 provides guidance on modifying the benchmark for the circumstances of smaller, less complex, entities.

Selecting a Percentage. The next step in making a preliminary judgment about planning materiality is to specify a percentage to apply to the benchmark. AU-C 320B.A10 explains that a relationship exists between the percentage and the chosen benchmark. For example, a percentage applied to a net amount, such as net costs (costs less revenues) will normally be higher than a percentage applied to total cost or total revenue. AU-C 320B, however, contains no guidance or specific examples of appropriate percentages. Nevertheless, certain guidelines have evolved in audit practice. One factor that enters into the consideration of what point within the range of percentages for each benchmark the auditor ought to use is the stability versus volatility of the benchmark. The auditor needs to consider the facts and circumstances of the particular opinion unit and not automatically gravitate to the lower or higher end of the range.

The selection of a percentage from a range of percentages for a particular benchmark is also influenced by the need to revise planning materiality as the audit progresses. As required by AU-C 320B.12, 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 opinion unit's history of audit adjustments, the stability of activity, 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 opinion unit with few if any audit adjustments and a relatively stable benchmark may warrant selection of a percentage at the higher end of the range.

Planning materiality decisions need to be reconsidered as the audit progresses. AU-C 320B.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 may use annualized interim financial information, the base amounts in the annual audited financial statements may differ. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments should be made. AU-C 320B.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, then the 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 320B.10 indicates that in addition to determining a planning materiality amount for the financial statements 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 reasonably be expected to influence economic decisions of users. Any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the opinion units 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.

SLG, Paragraph 4.80, 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.

b. Whether management may attempt to present disclosures in a way that obscures a proper understanding of the matters disclosed, such as by the use of unclear or ambiguous language.

c. The key disclosures in relation to the governmental unit and the environment in which the entity operates.

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. One example in an audit of a governmental unit would be the separate materiality levels for excluded items described earlier in this section. The second tier would be particular items of lesser amounts.

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 an opinion unit. For this purpose, the auditor needs to establish 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 an opinion unit's 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 opinion unit. 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 320B.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 320B.A3, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. AU-C 530B.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 as an extension of the concept of performance materiality used at the test level for 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.

Auditors need to establish at least one amount for performance materiality for each opinion unit. However, differing amounts can be established for various transaction classes, account balances, and disclosures. AU-C 320B.A15 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/opinion unit.
- 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.

The authors believe it is also 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.

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 appropriately 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 misstate the opinion unit. 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 misstatements would be performance materiality, which in this framework is an allowance for undetected misstatement. The uncorrected misstatement is the aggregation of factual misstatement plus judgmental and projected 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 *judgmental or projected 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 the authors using the framework described above is to determine performance materiality as a percentage of the auditor's judgment about the amount material to the opinion unit's 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.

The 50% guideline is based on the maximum adjustment normally made in monetary unit (MUS) sampling applications to allow for the projected or judgmental misstatements expected in sample results. Usually this 50% adjustment is conservative; that is, the extent of testing will be greater. Typically, for small and midsize applications, the authors believe that 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, an adjustment closer to 50% is necessary. Although this rule of thumb was developed for sampling applications, the authors believe that it is also useful and produces 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 Use of 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 capital assets can usually be examined to close tolerances. For other accounts, such as receivables, consideration of the 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—

- which items in a balance to examine 100%,
- whether it is necessary to sample the remaining items, or
- whether to apply analytical procedures instead of tests of details.

Deciding Whether to Extend Procedures. The planning materiality and performance materiality amounts discussed thus far 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. Though outside the scope of this course, discussions of the calculation and use of individually significant items, sometimes referred to as ISIs, and the combined evaluation of detected misstatements at the conclusion of the audit, are included in *PPC's Guide to Audits of Local Governments*.

Clearly Trivial Misstatements

As indicated at AU-C 450B.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. The authors suggest that 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. The amount of misstatements that will be passed at the workpaper level should be documented.

Documentation Requirements—Materiality. AU-C 320B.14 requires auditors 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 to items a. through c. above.

AU-C 450B.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, the authors recommend 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.

Single Audit Materiality

In a Single Audit, the auditor plans the audit of federal award programs so that there is only a relatively low risk of failing to detect noncompliance with requirements governing each major program that, when taken together, would be material to the program or the compliance requirement. Materiality considerations in a Single Audit are discussed in *PPC's Guide to Audits of Local Governments*.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk in a financial statement audit 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 315B.03 indicates that the auditor's objective 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. AU-C 315B.26 specifically requires the auditor to identify and assess risks of material misstatement at both the (a) opinion unit financial statement level, and (b) for classes of transactions, account balances, and disclosures at the relevant assertion level. AU-C 315B.27b requires that, for this purpose, the auditor should assess the identified risks and evaluate whether they relate more pervasively to the financial statements and potentially affect many assertions.

Risks of material misstatement at the opinion unit 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 relate identified risks at the financial statement level to what can go wrong in preparing 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 opinion unit financial statement level. The answer is, "No." The authors believe the risk assessment at the opinion unit financial statement level is 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 opinion unit financial statement level. The overall assessment of risk of material misstatement at the opinion unit 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.

Assessing Risks of Material Misstatement and Material Noncompliance in a Compliance Audit. The auditor's consideration of audit risk and materiality in a compliance audit, such as a Single Audit, is similar to the consideration in a financial statement audit. In a Single Audit, audit risk and materiality are considered together for each major program being tested as well as for each direct and material compliance requirement in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Responding to Risks at the Opinion Unit Financial Statement Level. The auditor should design and implement overall responses to address the assessed risks of material misstatement at the opinion unit level. AU-C 330B.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, the authors believe 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 2-7 provides examples of overall risks and potential responses at the financial statement level.

Exhibit 2-7

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 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 purpose 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 purpose for unusual transactions.
Going concern considerations that may impact future financing or other 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 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 a risk of management override of controls, AU-C 240B.29 states that overall responses should include the auditor—

- Considering the knowledge, skill, and ability of individual engagement team members when assigning and supervising them.
- Evaluating the client's selection and application of accounting principles, especially in subjective areas.
- Incorporating 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 2-8 provides examples of overall responses to fraud risks.

Exhibit 2-8

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 governmental unit.
- 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 315B.33 requires the auditor to document the identified and assessed of risks of material misstatement at the financial statement level. AU-C 330B.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 300B.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, 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 300B.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 audit 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 required. 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.

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 risk of material misstatement at the overall opinion unit financial statement level.
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and the action(s) 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 financial statement 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 External Resources. In developing the overall audit strategy the auditor incorporates decisions and judgments about overall responses to the risks of material misstatement at the opinion unit 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.* 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 end of the financial statement period. In an initial engagement for the audit of a governmental unit, it is not unusual for the auditor to be engaged at or after the fiscal year end. This eliminates the opportunity to even consider spreading work during the year by interim testing. In a continuing engagement, there are opportunities to spread work over the fiscal period. This may be very desirable if the auditor has several governmental unit clients with identical fiscal year ends. Because of the following characteristics of many governmental units, it is seldom appropriate or desirable to perform substantive tests of financial position statement account balances prior to the financial statement date.

- Part-time administrators who are inclined to take *short-cuts*.

- Accounting personnel with minimal education or experience in accounting.

- Too few employees to permit an adequate segregation of duties.

In testing transactions, the auditor normally selects transactions from the entire period under audit. If the auditor can obtain reasonably accurate estimates of the number and total dollar amount of the transactions for the fiscal period under audit, a portion of this work can be done at any convenient interim date. The remainder of the testing would be completed as part of year-end procedures.

Effect of Information Technology (IT) on Audit Strategy. A client's computer system also can affect the audit strategy because it can affect the risk of material misstatement, which influences the auditor's substantive procedures, and also can affect the availability and sufficiency of audit evidence, including the audit trail. In computerized financial reporting systems, much of the client's data is processed and stored only in electronic form. Thus, errors and fraud involving computer programs 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, that risk 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, the auditor considers whether the client's computer 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. The auditor also considers the amount and type of available data when designing audit procedures. It may be necessary to time the tests based on when the accounting data is available. Data availability can be affected by both the computer system and the client's data retention policies.

As discussed in Lesson 1, 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, the auditor needs 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 operations using IT, and no documentation of transactions is produced or maintained, other than through the IT system.

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 300B.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. AU-C 260B.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 needs to 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. One method for effectively establishing the overall audit strategy is by using the practice aids provided in *PPC's Guide to Audits of Local Governments*. AU-C 300B.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. However, 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, and there is no need for a separate memorandum.

Audit Summary Memo. One efficient approach to documenting the audit strategy and any changes to it in the audit of a governmental organization 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 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.

18. What is *planning materiality*?

    a. The auditor's application of performance materiality to a particular audit sampling procedure.

    b. The amount(s) set by the auditor for the financial statements as a whole to reduce the risk of uncorrected and detected misstatements to a low level.

    c. The auditor's judgment about materiality used to evaluate the effect of misstatement on the audit.

    d. The auditor's preliminary judgment about materiality at the financial statement level.

19. Which of the following statements best describes the auditor's assessment of the risks of material misstatement at the financial statement level?

    a. The auditor's measurement of audit risk should be recorded as a specific percentage.

    b. Risks of material misstatement at the financial statement level are often related to an entity's control activities.

    c. The auditor must identify and assess the risk of material misstatement at two levels.

    d. Auditors are required to separately assess inherent risk and control risk at the financial statement level.

20. The auditor's operational approach to achieving the audit objectives is called what?

    a. The audit strategy.

    b. The audit summary memo.

    c. The audit time estimate.

    d. The audit plan.

21. How might IT affect the audit strategy?

    a. A client's IT system generally does not affect the audit strategy.

    b. Errors and fraud are more obvious when related to computer programs.

    c. Material misstatement is higher if there are more people doing data processing.

    d. The sufficiency of electronic audit evidence depends on the effectiveness 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.)**

18. What is *planning materiality*? **(Page 98)**

    a. The auditor's application of performance materiality to a particular audit sampling procedure. [This answer is incorrect. As explained in AU-C 320B.A3, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. In other words, 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.]

    b. The amount(s) set by the auditor for the financial statements as a whole to reduce the risk of uncorrected and detected misstatements to a low level. [This answer is incorrect. *Performance materiality* is the amount or amounts set by the auditor at less than materiality for an opinion unit's 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 opinion unit. 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 320B.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. In other words, performance materiality is materiality at the account balance or transaction class level.]

    c. The auditor's judgment about materiality used to evaluate the effect of misstatement on the audit. [This answer is incorrect. *Evaluation materiality* is used in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the opinion unit financial statements.]

    d. **The auditor's preliminary judgment about materiality at the financial statement level. [This answer is correct. According to AU-C 320B.10, the auditor should determine a materiality level for the financial statements as a whole when establishing the overall audit strategy for the audit. AU-C 320B.A4 and SLG, Paragraphs 4.72–.77, clarify that in the context of a governmental audit, the concept of materiality for the financial statements as a whole, means establishing materiality levels for each opinion unit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. This concept of materiality helps with planning and performing the audit.]**

19. Which of the following statements best describes the auditor's assessment of the risks of material misstatement at the financial statement level? **(Page 106)**

    a. The auditor's measurement of audit risk should be recorded as a specific percentage. [This answer is incorrect. *Audit risk* in a financial statement audit is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.]

    b. Risks of material misstatement at the financial statement level are often related to an entity's control activities. [This answer is incorrect. Risks of material misstatement at the opinion unit 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.]

    c. **The auditor must identify and assess the risk of material misstatement at two levels. [This answer is correct. AU-C 315B.26 specifically requires the auditor to identify and assess risks of material misstatement at both the (1) opinion unit financial statement level and (2) for classes of transactions, account balances, and disclosures at the relevant assertion level.]**

d. Auditors are required to separately assess inherent risk and control risk at the financial statement level. [This answer is incorrect. This course suggests that the risk assessment at the opinion unit financial statement level is 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 opinion unit financial statement level.]

20. The auditor's operational approach to achieving the audit objectives is called what? **(Page 108)**

a. **The audit strategy. [This answer is correct. AU-C 300B.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, 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.]**

b. The audit summary memo. [This answer is incorrect. One efficient approach to documenting the information described above and any changes to it in the audit of a governmental organization is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting the issues identified in the audit just completed, and then update and change it in the current period to provide a basis for the current audit. However, the memo itself is documentation, not the actual approach described above.]

c. The audit time estimate. [This answer is incorrect. Though not required, an auditor is more likely to be efficient and effective if he or she is working under a time budget. However, this is a different consideration than the approach described above.]

d. The audit plan. [This answer is incorrect. The audit plan is more detailed than the approach described above and describes the nature, timing, and extent of procedures at the relevant assertion level.]

21. How might IT affect the audit strategy? **(Page 110)**

a. A client's IT system generally does not affect the audit strategy. [This answer is incorrect. A client's computer system can affect the audit strategy because it can affect the risk of material misstatement, which influences the auditor's substantive procedures, and also can affect the availability and sufficiency of audit evidence, including the audit trail.]

b. Errors and fraud are more obvious when related to computer programs. [This answer is incorrect. In computerized financial reporting systems, much of the client's data is processed and stored only in electronic form. Thus, errors and fraud involving computer programs and files may be less obvious than misstatements in manual records.]

c. Material misstatement is higher if there are more people doing data processing. [This answer is incorrect. Data processing duties are often concentrated in one or two employees. This is one factor that can create a higher risk of material misstatement.]

d. **The sufficiency of electronic audit evidence depends on the effectiveness of controls. [This answer is correct. When information is available only in electronic form, its sufficiency as audit evidence usually depends on the effectiveness of controls over its accuracy and completeness.]**

THE CONSIDERATION OF FRAUD

AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*, 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 of audit risk at the relevant assertion level for classes of transactions, account balances, and disclosures is beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Local Governments*. Because the auditor's consideration of fraud is not separate from consideration of risk at those levels, the *Guide* integrates the requirements of AU-C 240B within the overall risk assessment process. This section 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 material 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 intentional 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 240B.A1 explains that fraud, whether fraudulent financial reporting or misappropriation of assets, involves the three conditions enumerated above, and AU-C 240B.A76 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) 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 in a local government include:

- Misstating revenue/expenditure amounts to affect management compensation or performance assessment based on budgetary goals or program results.
- Overstating assets and revenues or understating liabilities and expenses/expenditures in order to comply with debt covenants.
- Overstating assets and revenues to improve or maintain current credit rating for tax exempt debt.
- Omitting disclosure of related party transactions to conceal violation of a debt covenant.

AU-C 240B.A6 indicates that fraudulent financial reporting often involves management override of controls that appear to be effectively operating to use such intentional techniques as the following:

a. Entering fictitious journal entries, particularly those entered near the end of an accounting period, to misstate operating results or other improper objectives.

b. Modifying assumptions or judgments in making accounting estimates.

c. Failing to recognize events or transactions occurring during the reporting period.

d. Accelerating or delaying the recognition of events or transactions that have occurred during the reporting period.

e. Misstating, omitting, or otherwise obscuring disclosures specifically required by GAAP or disclosures necessary to achieve fair presentation.

f. Concealing information that affects recorded amounts.

g. Structuring complex transactions to misrepresent operating results or financial position.

h. Altering terms or records concerning significant and unusual transactions.

The auditor considers who would have the motivation or incentive to intentionally misstate the financial statements. For example, in a period of fiscal stress, management may be under pressure to report to bond reporting agencies more favorable financial results than actually experienced in order to maintain the government's bond rating and to meet bond covenant requirements. Similarly, management may be under pressure to meet the legal operating budget and to maintain specified fund balance reserves. This could result in pressure to overstate revenues and understate or misclassify expenditures. Also, the auditor considers whether management is under significant pressure to achieve unduly aggressive budget or program goals or to stay within budget because of taxpayer initiatives or election promises. The government may also be under pressure to expend federal awards by a certain date or risk having to return the funds or to meet matching funds' requirements. These could result in pressure to overstate grant expenditures.

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 organization'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 an expense account, amounts reflected in the statement of activities may be misclassified, assuming the amounts are not recoverable.

A governmental entity that has a lack of management oversight of assets susceptible to misappropriation is at increased risk for misappropriation of assets. Cash collected on nonexchange transactions, such as permits and traffic tickets, as well as cash collected at multiple locations, such as golf fees, are examples of cash that is subject to misappropriation. Police vehicle parts, such as tires and batteries, are other examples of noncash assets that are portable and easily stolen. The auditor identifies items that employees can misuse at the government's expense. In addition, invoices from vendors may be inflated, requiring the entity to pay more for services than originally agreed-upon prices.

The Auditor's Responsibility for Fraud Detection

AU-C 240B.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. SLG, Chapter 4, Appendix A, Paragraph A-1, clarifies that for governmental entities, this responsibility is applied at the opinion unit level. AU-C 240B 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. For example, if the risk of intentional misstatement is that general fund expenditures are understated to make it appear that expenditures are within budgetary limits, the auditor's focus might be on what expenditures should be recorded in the general fund, or the completeness of general fund expenditures. In that case, analytical procedures based on reliable operating department data might be the most effective approach, but the auditor might want to supplement the analytical procedures with tests of details in certain circumstances. For example, if the risk of understatement of general fund expenditures includes delaying the recording of expenditures to a later period, the auditor might also review significant expenditures recorded after year end.

When assessing the risk of material misstatement due to fraud, the auditor considers the type of risk, that is, whether it relates to misappropriation of assets or fraudulent financial reporting; 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 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. It is important to ask if the risk of potential misstatement is a risk of overstatement (existence or occurrence) or a risk of understatement (completeness).

The auditor considers who would have the motivation or incentive to misappropriate assets or intentionally misstate the financial statements and the form the fraud would be likely to take. According to AU-C 240B.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 the areas in which 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.

As discussed in Lesson 1, AU-C 240B.17–.21 requires specific fraud-related inquiries of management, others within the entity, internal auditors, and those charged with governance. 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. AU-C 240.17, as amended by SAS No. 135, requires specific inquiries of management concerning whether significant unusual transactions have been entered; if so, the nature, terms, and business purpose (or lack thereof); and whether such transactions involved related parties. 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 at 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 200B.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 as a whole, are detected. AU-C 240B.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 fraud 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 governmental unit embezzles $5,000 per year for several years and hides the fraud by inflating expenses 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. However, many clients 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. Language that communicates the auditor's responsibility for fraud detection to the client can be included in the engagement letter. 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 240B.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 240B.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 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 240B.25 requires auditors to assess identified risks of material misstatements due to fraud. AU-C 240B.26 states that, based on a presumption that risks of fraud exist in revenue recognition, the auditor should evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. The auditor's considerations related to improper revenue recognition are integrated in various sections of this course. An explanation of the ways in which management of a governmental unit might intentionally misstate revenue, and a description of unusual or unexplained relationships relating to revenue that might be identified by revenue analytical procedures, were included in Lesson 1.

SLG, Paragraph 4.138, Appendix A-8, footnote 5, points out that revenues of a governmental unit include all resource inflows even if they are reported as other financing sources, additions, special and extraordinary items, etc. For example, because governmental units often have material grants with significant restrictions, the auditor might inquire of management or in-house legal counsel about grants received near period end and their knowledge of any unusual terms or conditions surrounding grants. The auditor would also consider whether management is under any pressure that might result in overriding controls, such as pressure to meet matching grant requirements. Material grants may have significant restrictions. If the auditor becomes aware that the client must comply with those restrictions or potentially repay the grant, the auditor might consider:

- How has management responded to this risk?
- What controls has management instituted to reduce the risk of misstatement? For example, senior management may have assigned someone to monitor compliance with grant restrictions and prepare periodic reports detailing how the organization is meeting the grant restrictions.

The auditor would then consider (a) whether this control could effectively mitigate the risk of misstatement and (b) the evidence available to assess whether it is operating effectively. Based on this risk assessment process, the auditor would then design substantive procedures in response to the remaining specific risk of misstatement due to fraud.

SLG, Paragraph 4.138, Appendix A-8, footnote 6, observes that some auditors believe that the risk of material misstatement due to fraudulent financial reporting is greater from misstated expenses or expenditures than from misstated revenues. Because of the nature of governmental transactions and financial reporting, there is a higher likelihood that expenses or expenditures will be intentionally misstated, such as intentionally understating expenses or expenditures for compensated absences or other postemployment benefits. AU-C 240B does not require a presumption of fraud risk for expenses or expenditures as it does for revenue, but the authors recommend that in the audit of a local government unit, the auditor ought to give careful consideration to risks of material misstatement due to fraud related to both improper revenue recognition and improper recognition of expenses or expenditures. If the auditor determines there is no fraud risk related to the misstatement of revenues, the rationale must be documented.

The following fraud risk assessment process is used to identify and respond to fraud risks; 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, those charged with governance, 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 government'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. Other examples of identifying risk factors that indicate a higher risk of fraudulent financial reporting include scanning transactions and reviewing expenditure/expense ratios to identify expenditures/expenses that were misallocated between functions or programs.

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, certain required responses to address the risk of management override of controls need to be considered. Overall responses were discussed earlier in this lesson. Specific responses to fraud risks and evaluating audit findings when the auditor believes fraud may have occurred is discussed in *PPC's Guide to Audits of Local Governments*.

Documenting the Fraud Risk Assessment. Although AU-C 240B defines a fraud risk assessment process that results in identifying and documenting specific 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 315B, which defines audit risk at the account balance or transaction class level as consisting of three components: inherent risk, control risk, and detection risk. AU-C 240B 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 in 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 by relevant assertion.

AU-C 240B.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.

THE CONSIDERATION OF LAWS AND REGULATIONS

GAAS Guidance on Auditing Compliance with Laws and Regulations

AU-C 250B.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 their determination of material amounts and disclosures in the financial statements. Examples are accruals and expenses affected by solid waste landfill laws, or revenue recorded under federal grants.

b. The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements. Although the effect may be indirect, compliance with those other laws and regulations can 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 laws or regulations related to environmental remediation, occupational safety and health, or food and drug administrations.

The auditor's objective during the planning stage 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.

AU-C 250B.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 250B.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. (Depending on the nature of the business or industry, those laws and regulations may include, for example, 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.

Several 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.

Provisions with a Direct Effect. AU-C 250B.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 250B.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.

Provisions of Other Laws and Regulations. In addition to inquiries of management about whether the entity is in compliance with other laws and regulations, AU-C 250B.14 requires the auditor to inspect correspondence with the relevant licensing or regulatory authorities.

Government Auditing Standards Requirements

Government Auditing Standards establish additional requirements related to (a) noncompliance with contracts and grant agreements; (b) abuse; (c) ongoing investigations or legal proceedings; and (d) communication of fraud, noncompliance, and abuse. Auditors might need to perform procedures to address these requirements, which are discussed in the following paragraphs.

Government Auditing Standards indicates auditors should design their audits to provide reasonable assurance of detecting misstatements resulting from noncompliance with the provisions of contracts or grant agreements that could have a material effect (direct or indirect) on financial statement amounts or other financial data significant to the audit objectives. In accordance with AU-C 250B, the auditor is required to follow up on indications that there have been violations that could have a material indirect effect on the financial statements. The procedures to follow up would include obtaining information, such as a legal opinion from the government's legal counsel, on whether there has been a violation and its effects on the financial statements. (AU-C 250B.17–.20 identifies specific audit procedures to be performed when noncompliance is identified or suspected.)

Requirements Related to Laws and Regulations. In the audit of a governmental unit, substantial attention is given to compliance with laws and regulations. Management is responsible for ensuring that the governmental unit complies with laws, regulations, and the provisions of contracts and grant agreements applicable to its activities; however, the auditor is responsible for obtaining an understanding of the provisions of laws, regulations, contracts, and grant agreements relevant to the entity, and how the entity is complying with them. The auditor should perform procedures that may identify instances of noncompliance with such provisions that may have a material effect on the financial statements. (The Yellow Book, at Paragraph 6.15, states that the auditors "should extend the AICPA requirements concerning consideration of noncompliance with laws and regulations to include consideration of noncompliance with provisions of contracts and grant agreements.")

The GAS/SA Audit Guide, Paragraph 3.47, indicates that the auditor might consider performing the following procedures to obtain an understanding of relevant compliance requirements:

- Consider information about compliance requirements obtained in prior years' audits.
- Discuss the compliance requirements with the audited entity's CFO, legal counsel, or grant administrators.
- Review applicable parts of directly related agreements, such as grant and debt agreements.
- Obtain an understanding from management of the revenue sources, review related agreements, and inquire about overall regulations applicable to accounting for the revenue.
- Obtain and review relevant sections of laws and regulations, including federal and state constitutions, articles of incorporation, charters, and bylaws.
- Review minutes of governing board meetings for enactment of laws and regulations or information about contracts or grant agreements.
- Inquire of oversight entities about applicable compliance requirements.
- Review information about applicable federal and state program compliance requirements.
- Review the guidance in applicable AICPA Audit and Accounting Guides and information from other professional organizations.
- Inquire of the grantor about the restrictions, limitations, terms, and conditions under which the grants were provided.

The auditor also should remain alert to the possibility of noncompliance being identified by other audit procedures that were applied.

Requirements Related to Waste and Abuse. *Government Auditing Standards* also establish requirements related to abuse. The concept of abuse is different from that of fraud or noncompliance and is not addressed in GAAS. The Yellow Book, at Paragraph 6.23, defines abuse as a behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. The Yellow Book states that abuse excludes fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements. The Yellow Book states that abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate.

The Yellow Book includes guidance regarding *waste* and *abuse*. The guidance on abuse, along with the concept of waste, is included in the application guidance relating to findings. Paragraph 6.20 of the Yellow Book indicates that the auditor's evaluation of internal control in a government environment may also include considering internal control deficiencies that result in waste or abuse. Paragraph 6.20 also indicates that "because the determination of waste and abuse is subjective, auditors are not required to perform specific procedures to detect waste or abuse in financial audits. However, auditors may consider whether and how to communicate such matters if they become aware of them. Auditors may discover that waste or abuse are indicative of fraud or noncompliance with provisions of laws, regulations, contract, and grant agreements." Under the Yellow Book, auditors must consider findings relating to waste and abuse along with other findings.

Requirements Related to Ongoing Investigations or Legal Proceedings. The Paragraph 6.12 of the Yellow Book requires the auditor to inquire of management of the audited entity whether any investigations or legal proceedings have been initiated or are in process with respect to the period under audit. Auditors should evaluate the effect of initiated or in-process investigations or legal proceedings on the current audit. Paragraph 6.14 indicates that it may be necessary to withdraw from the engagement or to defer work in order to avoid interfering with investigations.

Developing Elements of a Finding. If the auditor finds fraud, noncompliance, abuse, or internal control deficiencies, the auditor plans and performs additional procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives.

Communication Requirements. The Yellow Book establishes specific requirements for auditors to communicate fraud, noncompliance, and abuse, including requirements for reporting to outside parties in certain situations. These communication requirements are discussed further in *PPC's Guide to Audits of Local Governments*.

Compliance Audits

AU-C 935B, *Compliance Audits*, provides guidance on the circumstances in which the auditor is engaged (or legally required) to perform an audit of compliance in accordance with *Government Auditing Standards*, and a governmental audit requirement that requires an opinion on compliance, such as a Single Audit.

GENERAL PLANNING PROCEDURES AND FORMS

Most CPA firms develop an overall administrative audit program, commonly referred to as the *general program*, to document the technical and administrative matters needed to plan and complete an engagement. Many firms find that use of forms and other practice aids, such as those included in *PPC's Guide to Audits of Local Governments*, assist them in effectively addressing the engagement performance element of the firm's quality control policies and procedures as described in the Statements on Quality Control Standards issued by the AICPA.

Some firms complete information-gathering forms for new clients and update them annually for significant developments. The important consideration is the auditor's knowledge and understanding of these matters rather than the extent of the documentation. Nevertheless, auditors are required to document the (a) understanding of the entity, its environment and its internal control, including the sources of the information from which the understanding was obtained and the risk assessment procedures that were performed, and (b) assessment of the risks of material misstatement both at the financial statement level and the relevant assertion level and the basis for the assessment. In addition, auditors are required to document the specific risks of material misstatement due to fraud that are identified and, if auditors do not identify improper revenue recognition as a fraud risk, the reasons supporting that conclusion. The practice aids recommended here provide a convenient means of documenting the auditor's consideration of those matters.

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, 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.

The authors recommend a system that accounts for time by each major audit program area, for example, total time for cash. Other major engagement processes 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 is not instructed to 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, auditors need to 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 usable. The following paragraphs discuss steps the auditor can take to minimize the inefficiencies often experienced when requesting schedules from the client.

<u>List Everything Needed.</u> When preparing a list of schedules to be prepared by the client ("the PBC list"), the auditor ensures that the list is complete. 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.

<u>Make Sure the Client Understands What Information Is Being Requested.</u> When making requests for information from the client, the auditor is specific about what is needed. For example, the auditor avoids making requests such as "provide an analysis of activity in the deferred revenue account." Instead, the client is given an example of an acceptable format. If requesting a spreadsheet or another type of schedule, efficiencies may be gained by providing the client with a template. As a result, the auditor will receive the information in the requested format. The auditor reviews the PBC list in detail with the client to ensure that the client understands what information is being requested.

<u>Do Not Ask for Unneeded Information.</u> To avoid spending much (if any) time on insignificant accounts, 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.

<u>Prioritize Requests for Information.</u> 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. To facilitate this approach, request that the client prepare the schedules for the more complicated areas first.

<u>Stagger Due Dates for Requested Information.</u> Ideally, the client provides 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, be realistic when setting the due dates for requested information and not ask for everything to be prepared at once. As discussed in the previous paragraph, request that information for the critical areas be completed first.

<u>Provide Adequate Notice.</u> 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 will not be a difficult task if the auditor generally spends time in up front planning before fieldwork begins. Ask the client how much lead time is needed to adequately prepare for the audit.

<u>Work with the Client.</u> 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 should 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 usable format, attempt, instead, to get the client to do this task.

<u>Return Incorrect Schedules to the Client.</u> If the client provides the auditor with schedules that are prepared incorrectly, return them to the client for corrections. If the client does not have the time to revise the schedules, 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. Make such communication well enough in advance so that the auditor can reschedule fieldwork if necessary.

SELF-STUDY QUIZ

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

22. Which of the following might indicate that a government's financial statements may be misstated due to *misappropriation of assets*?
    a. Revenues are overstated to comply with debt covenants.
    b. Expenditure amounts are reduced to meet budget goals.
    c. A member of management diverts funds for personal use.
    d. Fictitious journal entries are added near the end of the accounting period.
23. Which of the following statements best describe an auditor's use of professional skepticism when considering fraud in a governmental audit?
    a. Without evidence to the contrary, client records should be accepted as genuine.
    b. Unless other evidence contradicts them, accept client responses to inquiries as true.
    c. If the auditor has experience with the client, he or she can rely on the client's integrity.
    d. Professional skepticism is not very important in relation to the risk of material misstatement due to fraud.
24. According to *Government Auditing Standards* (the Yellow Book), which of the following statements related to waste and abuse is true?
    a. Abuse is a concept outlined in GAAS.
    b. Abuse includes fraud and noncompliance.
    c. Abuse is behavior a prudent person would consider unreasonable.
    d. Specific procedures must be performed to detect waste and abuse.

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.)**

22. Which of the following might indicate that a government's financial statements may be misstated due to *misappropriation of assets*? **(Page 117)**

    a. Revenues are overstated to comply with debt covenants. [This answer is incorrect. This is an example of fraud resulting from fraudulent financial reporting, not misappropriation of assets. Misstatements resulting from fraudulent financial reporting are intentional misstatements, or omissions, of amounts or disclosures from the financial statements with the intent of deceiving financial statement users. An example would be overstating assets and revenues or understating liabilities and expenses/expenditures in order to comply with debt covenants.]

    b. Expenditure amounts are reduced to meet budget goals. [This answer is incorrect. Though also fraud, this type of fraud results from fraudulent financial reporting, not misappropriation of assets. The effect of misstatements from this type of fraud is that it may cause the financial statements not to be presented, in all material respects, in conformity with GAAP.]

    c. **A member of management diverts funds for personal use. [This answer is correct. Misstatements resulting from misappropriation of assets involve theft of the organization'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 (as in this case), stealing assets, or causing the entity to pay for goods and services not received.]**

    d. Fictitious journal entries are added near the end of the accounting period. [This answer is incorrect. This is an example of management override of controls, as described in AU-C 240B.A6. This allows an override of controls that appear to be effectively operating, and it is an example of fraudulent financial reporting (not misappropriation of assets).]

23. Which of the following statements best describe an auditor's use of professional skepticism when considering fraud in a governmental audit? **(Page 119)**

    a. **Without evidence to the contrary, client records should be accepted as genuine. [This answer is correct. According to AU-C 240B.13–.14, unless there is a reason to believe otherwise, auditors should accept client records and documents as genuine. Further investigation is needed if conditions indicate a document may not be authentic or its terms have been modified or not disclosed.]**

    b. Unless other evidence contradicts them, accept client responses to inquiries as true. [This answer is incorrect. As described in AU-C 240B.13–.14, if inconsistent, vague, implausible, or otherwise unsatisfactory responses are made to inquiries of management, those charged with governance, or others, investigate further. The auditor should not wait for other evidence to do so.]

    c. If the auditor has experience with the client, he or she can rely on the client's integrity. [This answer is incorrect. AU-C 240B.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.]

    d. Professional skepticism is not very important in relation to the risk of material misstatement due to fraud. [This answer is incorrect. 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.]

24. According to *Government Auditing Standards* (the Yellow Book), which of the following statements related to waste and abuse is true? **(Page 123)**

    a. Abuse is a concept outlined in GAAS. [This answer is incorrect. The Yellow Book establishes requirements related to abuse. The concept of abuse is *not* addressed in GAAS.]

    b. Abuse includes fraud and noncompliance. [This answer is incorrect. The Yellow Book states that abuse *excludes* fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements.]

    c. **Abuse is behavior a prudent person would consider unreasonable. [This answer is correct. The Yellow Book, at paragraph 6.23, defines abuse as a behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances.]**

    d. Specific procedures must be performed to detect waste and abuse. [This answer is incorrect. The Yellow Book, Paragraph 6.20, states that because the determination of waste and abuse is subjective, auditors are *not* required to perform specific procedures to detect waste or abuse in financial audits. However, auditors may consider whether and how to communicate such matters if they become aware of them.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 1—Risk Assessment Procedures and Planning (ALGTG211)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. 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 those 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 the PDF and can be printed if needed.

2. **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 $109 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.

3. **PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. 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
     ALGTG211 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.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 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 $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (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.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **April 30, 2022**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 1—Risk Assessment Procedures and Planning (ALGTG211)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. Which of the following statements best describes audit planning?
   a. It is a discrete phase of the audit and typically performed at the beginning of the engagement.
   b. It is a discrete phase of the audit and typically performed before the engagement letter is sent.
   c. It is an iterative process that continues until an understanding of the entity, its environment, and internal control is achieved.
   d. It is an iterative process that starts when the engagement is accepted and continues throughout the whole engagement.
2. Which of the following is a characteristic of governments that governmental auditors should take into consideration?
   a. Meetings of governing bodies are typically conducted behind closed doors, away from the public's view.
   b. Actions may be mandated or otherwise affected by laws, regulations, and provisions of contracts or grant agreements.
   c. Reliable and generous funding often allows management to hire more staff to keep the workload manageable.
   d. It is unusual for a governmental entity to prepare its financial statements using generally accepted accounting principles (GAAP).
3. What provides the basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels?
   a. The understanding of the entity and its environment.
   b. Preliminary engagement procedures.
   c. Risk assessment procedures.
   d. Management inquiries.
4. Which of the following statements best describes inquiries made of management and others?
   a. Making inquiries is optional and auditors should typically focus elsewhere when doing risk assessment.
   b. While some inquiries are necessary during an audit, they are typically performed later, once risk assessment is complete.
   c. If enough inquiries are made, auditors can eliminate the performance of other risk assessment procedures.
   d. Inquiries are a critical risk assessment procedure, but they cannot be used alone to identify risks.

5. Auditors are required to make inquiries about which of the following of those charged with governance in relation to related-party transactions?

   a. Their understanding of significant relationships and transactions with related parties.

   b. How many social interactions they have had with related parties since the last audit.

   c. The annual income of any related parties the entity does business with.

   d. The personal address and family details of each related party.

6. Under what circumstances might auditors consider limiting the analytical procedures they plan to apply as part of the risk assessment process?

   a. Several large audit adjustments are expected.

   b. AU-C 315B indicates that analytical procedures are not necessary.

   c. There is reason to believe that fraud may have been committed.

   d. Then entity uses specific accounting estimates listed in AU-C 540B.

7. Often, observation and inspection procedures do which of the following?

   a. Help auditors decide what inquiries to made of management.

   b. Corroborate or follow-up on the results of inquiries.

   c. Identify the absence of an expected relationship or the presence of one that is unexpected.

   d. Determine whether the entity is able to continue as a going concern.

8. According to AU-C 220B, who takes responsibility for the direction, supervision, and performance of a governmental audit?

   a. A low-level staff member with extra time.

   b. A specialist.

   c. The engagement partner.

   d. The head of the firm.

9. According to the recommendations of this course, it is a best practice for whom to attend the engagement team discussion?

   a. The whole firm.

   b. The whole engagement team plus specialists or component auditors.

   c. All external specialists who worked on prior engagements.

   d. The engagement partner and the client's legal counsel.

10. When obtaining an understanding of a governmental client and its environment, the auditor's process should be focused on what?

    a. Contacting all related parties to schedule extensive interviews.

    b. Obtaining enough general knowledge to be able to manage the entity.

    c. Matters that can cause an opinion unit to be materially misstated.

    d. The audit procedures that the auditor routinely provides in similar engagements.

11. A government's operation, governance, existing and future investments, structure, and financing all contribute to the auditor's understanding of what?

    a. The nature of a governmental entity.

    b. The measurement and review of the performance of a governmental entity.

    c. The industry, regulator, and other external factors that affect a governmental entity.

    d. The selection and application of a governmental entity's accounting policies and estimates.

12. The structure of a governmental unit and its governance are affected by which of the following?

    a. The political environment in which it operates.

    b. Its budget and program performance.

    c. The incentive of its employees to commit fraud.

    d. The allocation of administrative responsibility.

13. Which of the following statements best describes an aspect of the auditor's understanding of the government's selection and application of accounting policies and accounting estimates?

    a. The understanding helps auditors consider the risk of material misstatement at the financial statement level only.

    b. The understanding helps auditors assess what may go wrong when financial statements are prepared and relevant risks of material misstatement.

    c. The accounting principles prescribed by accounting pronouncements are not a significant component of this understanding.

    d. Management bias in selecting accounting principles does not apply since governments are not run for profit.

14. Minerva is engaged to perform a governmental audit. While obtaining an understanding of the entity and its environment, she determines that fraud risk factors are present. How will this affect the engagement?

    a. Minerva is required to withdraw from the engagement immediately, as the integrity of the governmental unit is now questionable.

    b. Minerva is required to change her overall audit approach to incorporate more responses to the fraud risk factors.

    c. Minerva should determine if the risks call for an overall response; one specific to a certain account balance, transaction, or disclosure at the relevant assertion level; or both.

    d. Minerva should note the fraud risk factors and provide a list of them to management, but she is not required to adapt her audit approach in any way.

15. What are the five elements of internal control discussed in COSO's *Internal Control—Integrated Framework*?

    a. Control environment, risk assessment, information and communication, monitoring, and entity-level and activity-level controls.

    b. Control environment, risk assessment, information technology (IT) controls, monitoring, and entity-level and activity-level controls.

    c. Risk assessment, information and communication, IT controls, monitoring, and control activities.

    d. Control environment, risk assessment, information and communication, monitoring, and control activities.

16. An auditor's understanding of internal control must be sufficient to do which of the following?

    a. 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.

    b. Determine whether internal controls are effective as described or documented and how the controls work on an independent basis.

    c. Provide a framework for the understanding and the subsequent audit that is based on the five elements of internal control outlined by COSO.

    d. Provide limited evidence to support an auditor's default decision to label the audit as having high control risk.

17. What is the main determining factor when considering how IT will affect an entity's internal control?

    a. The size of the entity.

    b. The nature and complexity of the IT system.

    c. The amount of associated cybersecurity risk.

    d. Whether the auditor needs to consult an IT specialist.

18. Where would an auditor start when using a top-down approach for obtaining an understanding of internal control?

    a. At the financial statement level.

    b. At the individual control activity level.

    c. With identifying the risks of material misstatement.

    d. By identifying controls that mitigate risk for certain control objectives.

19. After obtaining an understanding of a governmental unit's internal control, the auditor should understand which of the following?

    a. All of the unit's controls and control activities.

    b. The key controls primary to achieving control objectives.

    c. The controls and control activities specifically indicated by management.

    d. A sample of the unit's controls and control activities selected randomly.

20. What element of internal control sets the entity's tone, influences its people's control consciousness, and serves as the foundation for all the other elements of internal control?

    a. Control environment.

    b. Information and communication.

    c. Monitoring.

    d. Risk assessment.

21. Audit evidence for which of the elements of internal control is most likely to **not** be documented?

    a. Control activities.

    b. Control environment.

    c. Monitoring.

    d. Risk assessment.

22. Which of the following is more likely to increase the risks associated with an audit client?

    a. Long-time personnel.

    b. Slow and steady growth.

    c. Operations that stay the same.

    d. New accounting standards.

23. Which of the following refers to the entity's financial reporting system, including its accounting system; the procedures and records used to initiate, authorize, record, process, and report the entity's transactions; and accountability over assets, liabilities, and equity?

    a. Control environment.

    b. Communication.

    c. Information.

    d. Monitoring.

24. Charlie is engaged to audit a governmental unit. As part of the engagement, he reviews whether bank reconciliations are prepared on a timely basis, customer complaints about the billing process of enterprise funds, and the reporting system that tracks timely collections. Information in these areas will help Charlie obtain an understanding of which element of his client's internal control?

    a. Control environment.

    b. Information and communication.

    c. Monitoring.

    d. Risk assessment.

25. Under what circumstances are general IT controls most likely to be relevant?

    a. The client's IT environment was purchased from an outside vendor with no modifications.

    b. Client personnel have no access to the source code of important programs and applications.

    c. The client continued to use its existing IT system during the most recent financial statement period.

    d. The client is quite large and uses customized software that was created in-house.

26. The detailed aspects of an entity's financial reporting system and the internal control element of its control activities are considered what?

    a. Activity-level controls.

    b. Entity-level controls.

    c. General IT controls.

    d. Monitoring activities.

27. According to AICPA Technical Q&A 8200.12, *Use of Walkthroughs*, how often might an auditor wish to complete a walkthrough for significant accounting cycles?

    a. Every five years.

    b. Every three years.

    c. Every other year.

    d. Every year.

28. An auditor's understanding of control activities should do which of the following?

    a. Cover all control activities used by the entity.

    b. Cover all control activities used by governments nationwide.

    c. Cover only those control activities that are relevant to the audit.

    d. Cover only those control activities flagged as important by the entity's management.

29. Which of the following statements best describes planning materiality?

    a. Auditors cannot designate an amount as material if it is below planning materiality.

    b. The determination of planning materiality is primarily qualitative, not quantitative.

    c. Professional judgment is not used in the determination of planning materiality.

    d. The auditor's determination of planning materiality is based on the needs of financial statement users.

30. How might materiality be affected when an audit is performed under *Government Auditing Standards* (the Yellow Book)?

    a. The materiality level may be higher than in a GAAS audit.

    b. The materiality level may be lower than in a GAAS audit.

    c. The materiality level can be determined using specific Yellow Book benchmarks.

    d. The materiality level can be assigned by public regulators.

31. What may be considered the most important part of determining planning materiality?

    a. Selecting a benchmark.

    b. Selecting a percentage.

    c. Choosing the highest end of a percentage range.

    d. Making sure the benchmark is not volatile.

32. How is planning materiality affected by specific transaction classes, account balances, and disclosures of lesser amounts?

    a. Planning materiality is not affected by these things; the planning materiality amount at the financial statement level should be used for the whole audit.

    b. If, based on user perceptions of such items, lower materiality amounts are needed, the auditor can develop them in addition to the overall planning materiality amount.

    c. Lesser materiality amounts are only needed for such items if requested by management or those charged with governance.

    d. If such items occur with enough frequency, the auditor should choose unique planning materiality amounts and not use an overall financial statement amount.

33. Performance materiality is set at what level?

    a. The financial statement level.

    b. The individual account balance, transaction class, or disclosure level.

    c. Both the financial statement level and the individual account balance, transaction class, or disclosure level.

    d. The level at which the evaluated misstatements would be considered clearly trivial.

34. Which of the following governmental auditors has correctly responded to increased risks at the opinion unit financial statement level?

    a. Fred emphasizes that his audit team should rely on past experience with the client's integrity.

    b. Angelina assigns staff with lower experience levels to perform the bulk of the engagement.

    c. George trusts his team and lessens the time he spends supervising them.

    d. Katie selects audit procedures with a greater level of unpredictability.

35. How is the initial audit strategy used throughout the audit?

    a. Once developed, the audit strategy should stay the same.

    b. The audit strategy can only change with approval from those charged with governance.

    c. The auditor should update or change the audit strategy as needed throughout the audit.

    d. The audit strategy is a rough guideline that can be deviated from at will.

36. What three conditions are generally present when fraud occurs?

    i. Incentive/pressure
    ii. Intention
    iii. Culpability/lack of integrity
    iv. Attitude/rationalization
    v. Opportunity
    vi. Pleasure/justification

    a. i., iii., and vi.

    b. i., iv., and v.

    c. ii., iv., and vi.

    d. iii., iv., and v.

37. Which of the following statements best describes a governmental auditor's responsibility for fraud detection?

    a. The auditor is responsible for finding any fraud that affects the financial statements.

    b. The auditor is responsible for risks of fraudulent financial reporting but not misappropriation of the assets.

    c. The auditor's responsibility for fraud is applied at the opinion unit level.

    d. The auditor's process should be based on the idea that fraud does not exist in revenue recognition.

38. According to AU-C 250B.06, auditor's responsibilities related to the entity's compliance with laws and regulations differ based on what?

    a. Whether the entity is a governmental unit.

    b. Whether the laws and regulations have a direct effect on the financial statements.

    c. Whether the auditor is engaged to perform a compliance audit under AU-C 935B.

    d. Whether the client has been guilty of abuse or noncompliance in the past.

39. When should a final audit time estimate be prepared?

    a. At the conclusion of the prior-year audit engagement.

    b. When this year's audit engagement is accepted.

    c. After this year's engagement letter is signed.

    d. After this year's planning stage is complete.

40. Which of the following auditors has most effectively communicated with his or her client about the client-prepared schedules needed for the audit?

    a. Lily staggers the due dates for schedules so that they align with her planned order of tasks when she starts fieldwork.

    b. Arthur asks his client to prepare a wide variety of schedules early on, prior to determining which ones he will need.

    c. Molly makes the corrections on incorrect schedules herself so that the client can focus on other schedules that she needs.

    d. James limits his communications with the client about schedules so as not to overwhelm or distract them.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Local Governments—Course 1—Risk Assessment Procedures and Planning (ALGTG211)

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	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
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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Your Name (optional): ______________________ Date: ______________

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Please indicate your answers by filling in the appropriate circle as shown:
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Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
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4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
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GLOSSARY

Activity-level controls: These controls process and operate at the assertion level rather than at the overall financial statement level. They are directly related to initiating, authorizing, recording, processing, correcting, transferring to the general ledger, and reporting the entity's transactions. They typically refer to the internal control component of *control activities* along with the detailed aspects of the financial reporting system.

Audit plan: This documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. It is more detailed than the *audit strategy* and is sometimes called an *audit program*.

Audit risk: In a financial statement audit, this is 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. A high-level description of the audit scope, timing, and direction, including 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.

Communication: This component of internal control, as discussed in the *COSO framework*, is the process of providing an understanding of roles and responsibilities to individuals within the organization regarding internal control over financial reporting.

Control environment: This component of internal control, as discussed in the *COSO framework*, sets the tone of an entity and influences the control consciousness of its people. It is the foundation for all other components of internal control and provides structure and discipline. Its important elements include the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control.

Control activities: The policies and procedures that help ensure that management directives are carried out. In other words, these are the actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting. They usually involve (1) a policy that establishes what ought to be done and (2) the procedure that implements the policy.

Control objectives: These state the purpose of a control (or controls) in relation to risk and "what could go wrong" in the financial statements. They should be considered by the auditor during the process of identifying controls and evaluating their design and implementation. For *entity-level controls*, these may also be called *control principles*.

COSO framework: This framework comes from *Internal Control—Integrated Framework* produced by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). It defines and describes five elements of internal control—*control environment, risk assessment, information* and *communication, monitoring*, and *control activities*.

Cybersecurity: This encompasses all information technology (IT) related controls in an entity's IT platform that guard against unauthorized access.

Cybersecurity risk: 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.

Entity-level controls: These controls typically have a pervasive effect on an entity's system of internal controls and can, therefore, potentially influence the design and operating effectiveness of other controls. They are made up of the internal control components of the *control environment, risk assessment, information* and *communication* (excluding the financial reporting system), and *monitoring*. The IT environment and general IT controls are also considered entity-level controls.

General Information Technology (IT) controls: Policies and procedures that relate to many applications and support effective functioning of application controls. For IT, such general controls ordinarily include those related to (1) IT strategic planning and risk management, (2) data center and network operations, (3) physical security and access to programs and data, and (4) program changes and systems acquisition and development. They relate to all automated applications, including user-developed spreadsheet applications.

Information: This component of internal control, as discussed in the *COSO framework*, 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.

Key controls: Controls that are considered primary to achieving a *control objective*. It is often most efficient and effective for auditors to focus on these controls. They are important because their failure could materially affect the relevant assertion but might not be detected in a timely manner by other controls. They 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.

PBC list: This is a list of schedules to be prepared by the client. Preparing such scheduled for the auditor will allow the client to save audit fees, as well as allow for a more efficient audit. The PBC list should be provided to the client before fieldwork begins.

Performance materiality: Materiality at the account balance or transaction class level.

Planning materiality: The preliminary judgment about materiality at the financial statement level.

Professional skepticism: An attitude that includes a questioning mind.

Monitoring: This component of internal control, as discussed in the *COSO framework*, is a process by which an entity assesses the quality of its internal control over time. It involves accessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. It can also reveal evidence or symptoms of fraud.

Risk assessment: This component of internal control, as discussed in the *COSO Framework*, is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives.

Risk assessment procedures: Audit procedures performed to support the auditor's assessment of the risk of material misstatement. The procedures performed to obtain an understanding of the entity and its environment, as well as its internal control are considered risk assessment procedures.

Scoping activities: These are performed after an overall strategy for obtaining and documenting the understanding of internal control has been developed. They help the auditor know where to direct his or her efforts and provide a clear vision of what is significant at the entity.

Significant risks: An auditor's understanding of internal control should include a governmental unit's programs and controls that address risks of material misstatement that are considered this type of risk. Fraud risks are always considered significant risks. Also, such risks often relate to nonroutine transactions. Revenue recognition issues often pose significant risks, as well.

Tolerable misstatement: 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.

Top-down approach: This approach to understanding internal control begins at the financial statement level and works down to the individual activity control level. It improves 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.

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COMPANION TO PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS

COURSE 2

IMPORTANT CONSIDERATIONS FOR PERFORMING GOVERNMENTAL AUDITS (ALGTG212)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course takes a look at a variety of issues related to governmental audit engagements. Lesson 1 provides preliminary knowledge auditors need before taking on this type of engagement, such as information on the applicable professional standards and auditing requirements. Lesson 2 discusses how to assess risks and develop a detailed audit plan. Lesson 3 takes a detailed look at performing substantive procedures in this type of audit.
PUBLICATION/ REVISION DATE:	April 2021
RECOMMENDED FOR:	Users of *PPC's Guide to Audits of Local Governments*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of governmental auditing
CPE CREDIT:	7 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*. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's *Government Auditing Standards*.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by **April 30, 2022**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Preliminary Information about Governmental Audits

Completion of this lesson will enable you to:
- Identify governmental units and the professional auditing and accounting standards that apply to governmental audits.

- Recognize the basic GASB financial reporting requirements for governmental entities, requirements that apply when special-purpose frameworks are used, and the basic auditing requirements for governments.

Lesson 2—Assessing Risks and Developing the Detailed Audit Plan

Completion of this lesson will enable you to:
- Recognize best practices for identifying and assessing risks of material misstatement at the relevant assertion level.
- Determine what special considerations apply to the consideration of fraud risks, and how to respond to risk assessment and prepare the detailed audit plan.

Lesson 3—Substantive Procedures

Completion of this lesson will enable you to:
- Identify what substantive procedures are required in every audit and how to choose other substantive procedures.
- Recognize best practices for tests of details and substantive analytical procedures.
- Determine what other issues may arise related to substantive procedures and what timing for such procedures is appropriate.

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Lesson 1: Preliminary Information about Governmental Audits

INTRODUCTION

PPC's Guide to Audits of Local Governments (the *Guide*), upon which this course is based, discusses in detail the requirements for audits of governmental entities. It covers the following types of interrelated auditing requirements:

- American Institute of Certified Public Accountants (AICPA) generally accepted auditing standards (GAAS).
- *Government Auditing Standards* issued by the Comptroller General of the United States (the Yellow Book).
- The Single Audit Act and Office of Management and Budget's (OMB) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) (also referred to as Single Audits).

The three types of auditing requirements build on each other. That is, an auditor performing a Yellow Book audit also has to follow GAAS. An auditor performing a Single Audit also has to perform a Yellow Book audit.

That *Guide* provides a streamlined, technically sound audit approach for governmental entities. It provides auditors a flexible, adaptable audit process that is thorough, yet practical; effective; and efficient. The audit approach in that *Guide* enhances audit quality by ensuring compliance with the auditing standards. Further, auditors can consistently apply this effective audit process across all governmental audit engagements, which helps to ensure compliance with the firm's system of quality control and minimize firm risk and legal liability exposure.

That *Guide* shows the auditor of a local governmental unit how to plan and conduct effective audits that meet professional standards without unnecessary and unproductive procedures. It builds on the guidance in *PPC's Guide to Audits of Nonpublic Companies* and tailors much of that guidance to specific governmental audit situations. While *PPC's Guide to Audits of Local Governments* makes some references to *PPC's Guide to Audits of Nonpublic Companies*, it is designed to be freestanding and used independently.

This course takes a look at three subjects from that Guide, all of which provide information that auditors should be familiar with when auditing a governmental entity. Lesson 1 begins with a basic discussion of the principle of governmental units, which is followed by a basic listing of the authoritative auditing literature and the governmental accounting standards auditors will need to be familiar with. It goes on to discuss certain GASB reporting requirements for governmental financial statements under GASB, as well as those that apply when the financial statements are prepared using a special-purpose framework. It concludes with a discussion of auditing requirements for governments.

Lessons 2 and 3 take a more in-depth look at two issues auditors face during a governmental audit engagement. Lesson 2 discusses risk assessment and the development of a detailed audit plan, while Lesson 3 examines an auditor's performance of substantive procedures.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify governmental units and the professional auditing and accounting standards that apply to governmental audits.
- Recognize the basic GASB financial reporting requirements for governmental entities, requirements that apply when special-purpose frameworks are used, and the basic auditing requirements for governments.

Which Governmental Units Are and Are Not Covered

PPC's Guide to Audits of Local Governments and this course provide guidance most particularly applicable to cities, towns, townships, boroughs, villages, and school districts, which together constitute over half the total number of governmental units in the United States. It is generally applicable to the other types of governmental units, but those other units also have unique characteristics or accounting or auditing concerns that are not considered in this guidance. It is important to note that the financial statements of a city, town, etc., might have to include the operations of special districts or other organizations to conform to GAAP when certain conditions are met. Thus, the auditor might need to refer to specialized accounting and auditing literature for additional guidance. In addition to the AICPA Audit and Accounting Guides, *State and Local Governments* (SLG), and *Government Auditing Standards and Single Audits* (GAS/SA), which are referred to as needed, the following two industry-specific guides include accounting guidance for governmental entities that has been cleared by GASB:

- AICPA Audit and Accounting Guide, *Health Care Entities*.
- AICPA Audit and Accounting Guide, *Gaming*.

The accounting and financial reporting guidance in the above guides that has been cleared by GASB constitutes category B guidance for applicable governmental entities. Auditing guidance in those guides also should be considered during an audit of those entities.

Other AICPA audit and accounting guides that do not directly encompass governmental entities may provide useful guidance if a governmental entity is in a specialized industry or has transactions the guides address. Among those guides are the following:

- AICPA Audit and Accounting Guide, *Not-For-Profit Entities* (includes libraries, museums, and zoos, which may be operated in the public sector).
- AICPA Audit and Accounting Guide, *Employee Benefit Plans*.
- AICPA Audit and Accounting Guide, *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies*.
- AICPA Audit and Accounting Guide, *Investment Companies*.
- AICPA Audit and Accounting Guide, *Property and Liability Insurance Entities*.
- AICPA Accounting Guide, *Brokers and Dealers in Securities*.
- AICPA Audit Guide, *Special Considerations in Auditing Financial Instruments*.
- AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*.
- AICPA Audit Guide, *Analytical Procedures*

Although not cleared by GASB or made specifically applicable to governmental entities, accounting guidance in the above guides may be useful as nonauthoritative accounting literature, provided it does not conflict with or contradict authoritative governmental GAAP.

While most of the accounting and auditing guidance contained in *PPC's Guide to Audits of Local Governments* and this course can easily be used as a basis for auditing state governments or state agencies, it is not a focus of these publications. Audits of the federal government and federal agencies are beyond the scope of this course, specifically, and *PPC's Guide to Audits of Local Governments* in general.

What Is a Governmental Unit?

Definition. Paragraph 1.01 of the AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), indicates that the following organizations are *governmental organizations*:

- All public corporations and bodies corporate and politic.
- Other organizations that have any of the following characteristics:
  - Officers of the organization are elected by popular vote.
  - A controlling majority of the organization's officers are appointed by officials of one or more state governments.
  - A government could unilaterally dissolve the organization and retain the organization's remaining net assets.
  - The organization has the power to levy taxes. (That includes being able to enact and enforce the levy.)

Also, organizations are presumed to be governmental if they can directly issue tax-exempt debt (that is, not issue it through a state or municipal authority). However, the organization may rebut that presumption if none of the other governmental characteristics apply and compelling, relevant evidence exists that the organization should not be considered governmental.

Types of Governmental Units. According to the U.S. Census Bureau, there are approximately 90,000 state and local governmental entities in the United States. These are categorized as either general governments or special purpose governments. A *general government* is one which provides a range of services. A *special purpose government* is a legally separate entity that performs only one (or a few) specific activities. There are numerous types of special purpose governments, such as assessment districts, school districts, utilities, public employee retirement systems, governmental external investment pools, etc.

Common Examples. Most governmental entities will clearly fit into the first sentence of the definition of a *governmental organization* provided above. *Black's Law Dictionary* describes a public corporation as a municipality or a governmental corporation that has been created to administer public affairs or as an instrumentality of the state, founded and owned in the public interest. The following entities are common examples of governmental entities:

a. States, territories of the United States, and the District of Columbia.

b. Entities created by or under a state constitution, statute, statutory enabling legislation, or other local ordinance, including—

   (1) Cities.

   (2) Counties.

   (3) Towns.

   (4) Townships.

   (5) Villages.

   (6) Parishes.

   (7) Boroughs.

   (8) School districts.

   (9) Special districts.

   (10) Public authorities.

c. Entities considered to be a "municipal corporation" because they are declared by statute to be a "public corporation" or a "body corporate and politic." Legally separate special-purpose entities may be so designated to avoid limitations or requirements placed on the general government, such as limitations on debt issuance or civil service requirements.

Differences between Governmental Units and Business Enterprises

Governmental units differ from business enterprises in several important ways. One of the most significant differences is that governmental units do not have a strong profit motive. Instead, governmental units are empowered by law to render certain services to citizens and further empowered by law to raise revenues necessary to finance those services. Governmental units tend to adopt service programs that they deem necessary or desirable and then search for revenue sources to support them. For example, a city may increase its sales tax and designate the additional revenue for a new public transportation system. A governmental unit may levy taxes to pay for a service, and, once the tax is established, it may continue even after the need for the service declines. The tax revenues may then become available to support other desired programs. Thus, governmental units often establish a range of services to be rendered that is only indirectly influenced by constraints on revenue. This indirect relationship, plus the fact that the resources and revenues are usually extracted from the populace on an individually involuntary basis, influences the objectives, content, and format of governmental financial reports.

Another difference between governmental units and business enterprises is that political and social considerations motivate the activities and operating policies of most governmental administrations and elected officials to a significantly greater degree than they affect businesses. These considerations can affect the risk of material errors or fraud existing and, thus, the strategy for auditing the financial statements.

Exhibit 1-1 summarizes various distinctions between the business and governmental sectors relating to management goals and financial accounting, reporting, and auditing. The audit approach and related programs in *PPC's Guide to Audits of Local Governments* give due recognition to these different characteristics of governmental objectives, financial statements, and risk factors.

Exhibit 1-1

Distinguishing Characteristics of Governmental and Business Sectors

Factor	Business	Government
Management Goals	Economic (profit) orientation that centers on results of operations and cash flows.	Service orientation and concern for social and political matters. Economic concerns limited to availability of sufficient resources to accomplish service goals.
Primary Financial Statement Users	Management, investors, and creditors.	Citizens, administrators, legislative bodies, creditors, and providers of financial assistance.
Accounting Standards	Relatively large body of principles and standards. Accrual basis.	Relatively smaller body of specific guidance. Accrual basis for the government as a whole and either accrual or modified accrual basis for funds.

Factor	Business	Government
Financial Reporting	Statements that present financial position, results of operations, and cash flows.	Statements that demonstrate both fiscal and operational accountability with emphasis on the government's major funds and required budgetary comparison statements or schedules.
Primary Audit Needs	Audits in accordance with GAAS or PCAOB auditing standards.	Audits in accordance with GAAS plus, in many cases, audits in accordance with additional regulatory (governmental) audit standards.

THE AUTHORITATIVE AUDITING LITERATURE

Auditing Literature

Authoritative auditing guidance relevant to governmental units may be found in pronouncements that are general to both governmental and nongovernmental entities and in pronouncements specific to governmental units. The AICPA's Statements on Auditing Standards (SASs) and auditing interpretations and the AICPA *Code of Professional Conduct* are generally applicable to governmental audits. Within this general AICPA literature are some documents specific to governmental units. Specific auditing literature has also been issued by the U.S. Congress, the U.S. Government Accountability Office (GAO), and the Office of Management and Budget (OMB). The hierarchy for application of these pronouncements is discussed later in this lesson. Auditors are encouraged to consult the authoritative literature referenced in this course. It is intended to supplement, not replace, authoritative accounting and auditing guidance.

Generally Accepted Auditing Standards

Auditors of nonpublic entities, including state and local governments, should conduct their engagements in accordance with GAAS developed by the AICPA. The AICPA *Code of Professional Conduct* requires members to comply with SASs. This course is updated annually for changes in professional literature and includes guidance about how those changes might affect audits of local governments. However, auditors are responsible for awareness and timely implementation of new pronouncements. The authors recommend that firms have a system in place to ensure staff members are informed about current authoritative literature. Thomson Reuters offers Standards Tracker, a tool that may be accessed through Checkpoint, to assist in keeping up with changing standards.

Defining Professional Responsibility. The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200B.25):

- *Unconditional Requirements.* Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.
- *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200B.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

The auditor must document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement.

Use of the Terms *Must* and *Should*. This course uses the terms *must* and *should* in accordance with AU-C 200B.25. It also uses the term *is required* interchangeably with *should*.

Form and Structure of the Auditing Standards. Each auditing standard is divided into the following topics:

- *Introduction.* Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.
- *Objectives.* Establishes objectives that allow the auditor to understand what he or she should achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.
- *Definitions.* Provides key definitions that are relevant to the standard.
- *Requirements.* States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.
- *Application and Other Explanatory Material.* Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are included in this section.

A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

AU-C Section Organization. Within the AICPA *Professional Standards*, the auditing standards use "AU-C" section numbers. The organization of the AU-C sections is as follows:

- Preface.
- Glossary.
- AU-C Section 200–299: General Principles and Responsibilities.
- AU-C Section 300–499: Risk Assessment and Response to Assessed Risks.
- AU-C Section 500–599: Audit Evidence.
- AU-C Section 600–699: Using the Work of Others.
- AU-C Section 700–799: Audit Conclusions and Reporting.
- AU-C Section 800–899: Special Considerations.
- AU-C Section 900–999: Special Considerations in the United States.
- Appendixes.

  When a new auditing standard is issued, the AICPA Professional Standards include the new and the preceding standard.

Preface. AU-C Preface, *Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with generally accepted auditing standards (the principles). These principles are not requirements and are not authoritative. They provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The structure addresses the purpose of an audit, responsibilities of the auditor, performance of the audit, and reporting.

Changes to AU-C References. With the continued issuance of new auditing standards and the deferral of effective dates for other auditing standards, the AICPA made some unprecedented changes in how it organizes the SASs. The three "series" of AU-C references are as follows:

- AU-C XXX, the *core* series. The core or primary AU-C Section number with no alpha character after the number will be updated to include the latest SAS issued, regardless of its effective date, and will reflect the most recent literature. The core series contains all the auditing standards issued to date (through SAS No. 143 at the time this course was updated).

- AU-C XXXB series. The B series includes the auditing standards that apply before SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, is implemented and is a complete codification containing all AU-C standards before implementation of SAS No. 134. Each section is designated with a "B" suffix (AU-C XXXB, such as AU-C 700B). This section is intended to assist auditors and firms that are not implementing SAS Nos. 134–140 prior to the delayed effective date as a result of the issuance of SAS No. 141. Upon implementation of SAS Nos. 134–140, the AU-C XXXB series should not be used.

- AU-C XXXA series. The A series includes the auditing standards that apply *after* implementation of SAS No. 134 and the related reporting standards (that is, the standards up through SAS No. 141), but *before* implementation of SAS No. 142 or any subsequent SASs. Note that this is not a complete set of professional standards, but simply a bridge between the AU-C XXXB series and the AU-C XXX core series. Currently, this is limited to AU-C 500A, *Audit Evidence*, the related interpretation at AU-C 9500A, and AU-C 540A, *Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. (Amendments to other AU-C sections by those recently issued ASUs are not fully integrated into the core AU-C sections. Instead, there is a Note at the beginning of each affected core AU-C section referring the user to an appendix to either AU-C 500 or AU-C 540 for the related amendments.)

If the auditor is not early implementing SAS Nos. 134–140, the professional standards before SAS No. 134 apply. For example, you will find the extant literature for auditor's reports at AU-C 700B and the literature for auditor's reports with relevant amendments from SAS No. 134 are at AU-C 700. While this course generally uses AU-C XXXB references, it has been updated for the performance requirements through SAS No. 141. Any discussions that are effective after implementation of SAS No. 134 through SAS No. 140 are clearly indicated as being effective on or after December 15, 2021. Therefore, auditors can use the guidance in this course before or after implementation of these standards.

Overall Objectives and Requirements. AU-C 200B, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, contains the auditor's overall responsibilities in accordance with GAAS. The overall objectives of the auditor in conducting an audit of financial statements are as follows:

- Obtain reasonable assurance about whether the financial statements are free from material misstatement.

- In accordance with the auditor's findings, (a) report on the financial statements and (b) make the communications required by GAAS.

Though outside the scope of this course, *PPC's Guide to the Clarified Auditing Standards* summarizes the objectives for the AU-C sections in SAS Nos. 122–139.

AU-C 200B.15 states that the auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise or (b) law or regulation requires accepting the engagement and reporting on the financial statements.

AICPA *Code of Professional Conduct*. The AICPA *Code of Professional Conduct* provides guidance and rules that auditors need to comply with in connection with an audit engagement. As noted in AU-C 220B.A4, it sets forth the fundamental principles of professional ethics, including objectivity and independence. As discussed above, the auditor is required to be independent when performing an audit in accordance with GAAS. AU-C 200B.16 also requires auditors to follow ethical requirements that are relevant to the engagement.

The AICPA *Code of Professional Conduct* (the Code) includes two broad conceptual frameworks, one for members in public practice and one for members in business. The Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The Code provides conceptual frameworks that set forth requirements in those situations where the member has identified a threat to compliance with the rules in the Code, and the relationship or circumstance creating the threat is not covered within the Code.

The Code provides a numbering system with the reference preface of "ET." When applicable, this course provides references to the numbering system. Though outside the scope of this course, *PPC's Guide to Audits of Local Governments* provides additional discussion of certain independence considerations, including those related to client acceptance and continuance.

Quality Control

Statement on Quality Control Standards. Statement on Quality Control Standard No. 8, *A Firm's System of Quality Control* (QC 10), establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control (QC) for its accounting and auditing practice. SQCS No. 8 (QC 10) comprehensively addresses the quality control processes over a firm's accounting and auditing practice. The standard places an unconditional obligation on the firm to establish a QC system designed to provide reasonable assurance that the firm complies with professional standards and legal and regulatory requirements, and that it issues reports that are appropriate in the circumstances. *PPC's Guide to Quality Control* provides guidance and practice aids to assist firms in developing, implementing, and maintaining a system of quality control.

Quality Control Auditing Standard. AU-C 220B, *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 implement each element of quality control during the performance of an audit of financial statements. Thus, for every quality control element discussed in QC 10, AU-C 220B includes information that conveys how the firm ensures that the requirements of the QC standard are met in an audit engagement. The responsibility to ensure compliance with AU-C 220B is primarily placed on the audit engagement partner. However, certain requirements are also imposed on the engagement team and, if applicable, engagement quality control reviewer. In meeting the requirements of AU-C 220B, the engagement partner is permitted to delegate his or her responsibilities, and the engagement team may rely on the firm's quality control system unless the engagement partner has indicated that it is inappropriate to do so.

The objective is for the auditor to 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.
- In the circumstances, the auditor's report issued is appropriate.

AICPA Initiative on Enhancing Audit Quality. An ongoing AICPA initiative, *Enhancing Audit Quality* (EAQ), launched in May 2014 and focuses even more attention on the importance of engagement quality. This comprehensive effort not only is focused on specific quality issues that have arisen in the audits of private entities but is intended to align the objectives of all AICPA audit-related efforts to improve audit performance. In certain areas, peer reviewers and, where applicable, government oversight agencies, continue to note issues in audit quality. The AICPA has provided examples of matters noted in peer reviews for engagements with year-ends between January 1, 2019, and April 1, 2020, at **www.aicpa.org/InterestAreas/PeerReview/Community/PeerReviewers/examplesofmattersinpeerreviews.html**.The AICPA Professional Ethics Division published a December 31, 2019 report highlighting quality issues in government and not-for-profit audits noted in their technical reviews over the last two years. The complete report is available at **www.aicpa.org/content/dam/aicpa/interestareas/professionalethics/resources/tools/downloadabledocuments/common-deficiencies-report-govt-and-nfp-final.pdf**.

More information about the AICPA's EAQ initiative can be obtained on the AICPA's website at **www.aicpa.org/InterestAreas/PeerReview/EAQ.html**. Since 2016, the AICPA has provided an annual highlights and progress report on its EAQ initiative that covers key areas of focus for the year, other quality improvement activities, and information planned for future steps. The highlights and progress reports can be located on the AICPA's website at the previously mentioned URL.

Also in May 2016, the AICPA's Peer Review Board (the PRB) issued revisions to its Standards for Performing and Reporting on Peer Reviews, *Improving Transparency and Effectiveness of Peer Review*, as part of the audit quality initiative. Additionally, in November 2016, the PRB approved final wording changes to the peer review report and firm representation letter used when firms perform audits in accordance with *Government Auditing Standards*, including compliance audits under the Single Audit Act. These changes were effective for peer reviews commencing on or after January 1, 2017. This and other information on the AICPA's Enhancing Audit Quality Initiative can be located on the AICPA's website at **www.aicpa.org/interestareas/peerreview/pages/eaq.aspx.**

In 2018, the AICPA analyzed more than 400 peer review Matters for Further Consideration (MFC) to identify common violations related to risk assessment. This study and several other risk-assessment-related resources are available at **www.aicpa.org/eaq/aicpa-risk-assessment-resources.html**. Also, a Peer Review Program survey showed that over 40% of nonconforming audit engagements did not comply with professional standards due to a failure to obtain an understanding of internal control when identifying the risks of material misstatement. Several resources to help comply with requirements related to internal control are available at **www.aicpa.org/eaq/internal-control-resources.html**.

How PPC Guides Contribute to Audit Quality. If used properly based on the circumstances of the particular engagement, *PPC's Guide to Audits of Local Governments* and its practice aids contribute to performing audits in accordance with professional standards. That *Guide* has been updated for relevant professional standards, and, as noted in the introductory materials, the Tax and Accounting business of Thomson Reuters has voluntarily elected to undergo a peer review on an annual basis of its system for the development and maintenance of quality control materials.

The overall audit process outlined in that *Guide* (and discussed further later in this lesson) will help auditors achieve an audit performed in accordance with professional standards. Also, the authors recommend that, in addition to a careful review of the professional standards, the practice aids, where applicable, be applied to the relevant circumstances of audit engagements. Practice aids in that *Guide* typically incorporate relevant professional standards (as well as best practices and practical guidance). If the auditor decides to use other methods to perform and document audit procedures for matters addressed by a practice aid, the authors suggest that the practice aid be carefully reviewed to ensure that relevant requirements are incorporated in the audit procedures and documentation. That *Guide* also provides important *additional* guidance on professional standards, including other practical information, as well as how the practice aids may be applied to audit engagements. Of course, the auditor needs to apply professional judgement and skepticism, incorporate appropriate competence in the circumstances, and ensure due diligence throughout the audit process.

Specific Auditing Literature

The following deal specifically with governmental auditing:

- AU-C 935B, *Compliance Audits*, addresses the application of generally accepted auditing standards to a compliance audit, such as a Single Audit.
- Auditing Interpretations 1–3 of AU-C 265B (AU-C 9265.01–.10) provide guidance related to communication of deficiencies in internal control over compliance related to Recovery Act awards that have been identified at an interim date prior to the completion of a Single Audit. (The Interpretations provide illustrative language that may be used whenever the auditor chooses or is required to provide an early written communication of significant deficiencies or material weaknesses in internal control over compliance—not just for Recovery Act awards.)
- Auditing Interpretations 2–3 of AU-C 500B (AU-C 9500.23–.36) provide guidance related to sufficient appropriate audit evidence for audits of governmental employers that participate in cost-sharing or agent multiple-employer pension plans administered through trusts and equivalent arrangements that meet the criteria specified in GASBS No. 67, paragraph 3, and GASBS No. 68, paragraph 4.

- Auditing Interpretations 1–2 of AU-C 805B (AU-C 9805.01–.12) provide guidance related to audit reports for audits of governmental employers that participate in cost-sharing or agent multiple-employer pension plans administered through trusts and equivalent arrangements that meet the criteria specified in GASBS No. 67, paragraph 3, and GASBS No. 68, paragraph 4.
- Auditing Interpretation 1 of AU-C 600B (AU-C 9600.01–.02) provides guidance related to group audits and whether a government employer should consider a pension plan accounted for and reported under GASBS No. 68 to be a component.
- GAO *Government Auditing Standards, 2018 Revision* (the Yellow Book) incorporates GAAS and adds other requirements that together constitute generally accepted government auditing standards. These standards apply to certain audits, including Single Audits, of entities that receive federal, state, or local government financial assistance, or as required by law, such as state law, or contract. A link to the 2018 Yellow Book is included in *PPC's Government Documents Library* at GDL Gov. Doc. No. 2.
- Single Audit Act Amendments of 1996 (Public Law 104-156—The Act) is the federal statute that establishes a legal requirement for state and local governmental units expending stipulated amounts of awards to have an audit meeting specifications in the Act and related regulations. (In this course, references to the Single Audit Act also encompass the Single Audit Act Amendments of 1996. This is consistent with references in the GAS/SA Audit Guide.) The Act is included in *PPC's Government Documents Library* at GDL Gov. Doc. No. 1.
- AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), provides guidance on applying GAAS to audits of governmental financial statements. It also discusses accounting pronouncements and recognized practices that are unique to governments.
- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), provides guidance on the auditor's responsibilities when performing a Yellow Book audit or a Single Audit under the Uniform Guidance.

Generally accepted auditing standards and *Government Auditing Standards* are discussed in more detail later in this lesson.

Recent Auditing Standards Issued and Proposed

SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. In May 2019, the AICPA issued SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, a suite of auditor reporting standards. SAS No. 134 supersedes and replaces the extant guidance AU-C 700B, *Forming an Opinion and Reporting on Financial Statements*; AU-C 705B, *Modifications to the Opinion in the Independent Auditor's Report*; and AU-C 706B, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*; adds AU-C 701, *Communicating Key Audit Matters in the Independent Auditor's Report*; and amends a number of other AU-C sections. Key provisions of SAS No. 134 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. SAS No. 134 also introduces communication of key audit matters (KAMs), but this communication is not required in audits of nonissuers. However, KAMs are required to be included in the auditor's report if the auditor is engaged to report KAMs. SAS No. 134, as deferred by SAS No. 141, is effective for audits of financial statements for periods ending on or after December 15, 2021, with earlier implementation permitted.

Omnibus Statement on Auditing Standards—2019. In May 2019, the AICPA issued SAS No. 135, *Omnibus Statement on Auditing Standards—2019*. The Omnibus SAS resulted from the evaluation of three auditing standards that have been issued by the Public Company Accounting Oversight Board (PCAOB) since the AICPA's Auditing

Standards Board (ASB) completed its auditing standards clarity project. The SAS amends 13 sections of the Statements on Auditing Standards, including:

- AU-C 210B, *Terms of Engagement*.
- AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*.
- AU-C 260B, *The Auditor's Communication With Those Charged With Governance*.
- AU-C 265B, *Communicating Internal Control Deficiencies Identified in an Audit*.
- AU-C 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
- AU-C 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.*
- AU-C 510B, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*.
- AU-C 550, *Related Parties*.
- AU-C 560B, *Subsequent Events and Subsequently Discovered Facts*.
- AU-C 580B, *Written Representations*.
- AU-C 600B, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
- AU-C 930B, *Interim Financial Information*.
- AU-C 940B, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*.

AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, is amended to define significant unusual transactions and provide requirements for obtaining information for the evaluation of such transactions. Additional AU-C sections are also amended to enhance guidance regarding related parties and significant unusual transactions.

The changes to AU-C 260, *The Auditors Communication with Those Charged With Governance*, add requirements for the auditor to communicate views pertaining to the entity's significant unusual transactions and the possible effects of uncorrected misstatements on future period financial statements. In addition, the application material of AU-C 260 is amended for a variety of matters including those where the auditor consulted outside of the engagement team and concerns or complaints about account and auditing items that came to the auditor's attention.

AU-C 550, *Related Parties*, amendments are intended to increase the auditor's focus on related parties, relationships, and associated transactions. The SAS enhances existing requirements to identify related parties or significant related-party transactions that were previously unidentified or undisclosed. Also, the auditor's response to the risks of material misstatement relating to related parties, relationships, and associated transactions is enhanced by including procedures for testing the completeness and accuracy of related parties, relationships, and transactions.

In addition, amendments to AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, require communication to component auditors about the nature of relationships and transactions with related parties.

SAS No. 135 is effective for audits of financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141. The requirements of SAS No. 135 may be implemented early and are fully incorporated into the discussions in this course.

SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*. On July 10, 2019, the AICPA issued SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, which supersedes AU-C 720B, *Other Information in Documents Containing Audited Financial*

Statements. The superseded auditing standard is now codified in AU-C 720B and SAS No. 137 is codified in AU-C 720. The standard provides (a) clarification as to what other information is within the scope of the auditor's procedures, (b) additional guidance on the auditor's objectives in reading other information, (c) direction regarding the group auditor's responsibilities for reading other information when reference is made to a component auditor in the group auditor's report, and (d) new reporting requirements. SAS No. 137 is effective for audits of financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141, concurrent with SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. Early implementation is permitted. If necessary, this course includes discussions that apply both before and after the implementation of SAS No. 137.

SAS No. 138, *Amendments to the Description of the Concept of Materiality*. In December 2019, the Auditing Standards Board issued SAS No. 138, *Amendments to the Description of the Concept of Materiality*. The SAS eliminates inconsistencies between the description of *materiality* in the AICPA *Professional Standards* and the description of materiality used by the U.S. judicial system and other U.S. standard setters and regulators, such as the PCAOB. AU-C 200.07, as revised by SAS No. 138, describes matters as material "if there is a substantial likelihood that, individually or in the aggregate, they *would influence* the judgment made by a reasonable user" (as compared to the current auditing standard, which uses the phrase *could reasonably be expected to influence*). The differences in the *materiality* descriptions are subtle and are not expected to significantly change practice. SAS No. 138 is effective for audits of financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141 with early implementation permitted. It has been fully incorporated in this course.

SAS No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes from SAS No. 134*. In March 2020, the AICPA issued SAS No. 139, *Amendments to AU-C Sections 800,805, and 810 to Incorporate Auditor Reporting Changes from SAS No. 134*. SAS No. 139, as deferred by SAS No. 141, is effective for audits of financial statements for periods ending on or after December 15, 2021, with early implementation permitted.

SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137*. In April 2020, the AICPA issued SAS No. 140 to conform AU-C 725, 730, 930, 935, and 940 to the requirements of SAS No. 134 and SAS No. 137. SAS No. 140, as deferred by SAS No. 141, is effective for audits of financial statements for periods ending on or after December 15, 2021, with early implementation permitted. Additionally, AU-C 935B reflects changes from the Uniform Guidance, OMB Compliance Supplement, and the 2018 Yellow Book.

SAS No. 141, *Amendment to the Effective Dates of SAS Nos. 134–140*. On April 20, 2020, the Auditing Standards Board (ASB), via SAS No. 141, voted to defer the effective date of the following:

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*.
- SAS No. 135, *Omnibus Statement on Auditing Standards—2019*.
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA.*
- SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*.
- SAS No. 138, *Amendments to the Description of the Concept of Materiality*.
- SAS No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134*.
- SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137*.

These SASs, as issued, were to be effective for audits of financial statements for periods ending on or after December 15, 2020, with early implementation expressly prohibited for SAS Nos. 134, 136, 137, 139, and 140 (the Reporting Suite). While the ASB initially stated that it was their intent that all of these standards be adopted concurrently, in the April 2020 meeting, they clarified that SAS Nos. 135 and 138 do not prohibit early implementation, and early implementation was acceptable. They discussed the interrelation of the Reporting Suite and the importance of considering them together for implementation. For example, SAS No. 134 is the core standard for auditor's reports, but SAS Nos. 137 and 138 amend SAS no. 134, so it would not be appropriate to implement SAS No. 134 without also implementing SAS Nos. 137 and 138. SAS No. 141 defers the effective dates of all of these SASs by one year, to be effective for audits of financial statements for periods ending on or after December 15, 2021; however, early implementation is now permitted for all, including the Reporting Suite.

SAS No. 142, *Audit Evidence*. In July 2020, the AICPA issued SAS No. 142, *Audit Evidence*. SAS No. 142, which is now codified at AU-C 500, supersedes current guidance now codified at AU-C 500A (or AU-C 500B prior to amendments in SAS Nos. 134 through 141) moves guidance on the use of management specialists to AU-C 501, and amends various other AU-C sections. Key areas of change or potential improvement in audit quality covered by SAS No. 142 and amendments include use of automated tools and techniques, corroborative and contradictory information, conscious and unconscious bias, use of external information sources, and the nuances of reliability of information as audit evidence. (Auditors may use automated tools and techniques before implementation of SAS No. 142.) SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. Due to the delayed effective date, this edition of the course does not fully incorporate SAS No. 142.

SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. In July 2020, the AICPA issued SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. SAS No. 143 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. The standard retains the familiar requirement that the auditor's further procedures should include one or more of three approaches: (a) obtain evidence from events occurring up to the audit report date, (b) test how management made the estimate, or (c) develop the auditor's own point estimate or range. The new SAS adds requirements and guidance regarding assessment of risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting estimates. SAS No. 143, which is now codified at AU-C 540, supersedes *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is now codified at AU-C 540A (or AU-C 540B prior to amendments in SAS Nos. 134 through 141), and amends various other AU-C sections. SAS No. 143 is effective for audits of financial statements for periods ending on or after December 15, 2023. Due to the delayed effective date, this edition of the course does not fully incorporate SAS No. 143.

Proposed SAS, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. In August 2020, the AICPA issued an exposure draft, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The proposed SAS would supersede AU-C 315B and amend other auditing standards related to risk assessment. It is intended to enhance the auditor's ability to appropriately understand the entity's system of internal control, in particular relating to the auditor's work effort to obtain the necessary understanding, and determine risks of material misstatement, including significant risks. The revisions would also modernize the standard in relation to information technology considerations, including addressing related risks. The proposed standard introduces several new concepts and definitions related to inherent risk assessment and significantly enhances the related requirements. The effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2023. Future editions of the course will be updated for any new developments. Readers can follow this project at **www.aicpa.org**.

Proposed SAS, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. On November 4, 2020, the AICPA issued an exposure draft, *Amendments to AU-C Sections 501, 540 and 620 Related to the Use of Specialist and the Use of Pricing Information Obtained From External Information Sources*. The proposed SAS would provide enhanced guidance on (1) evaluating the work of management's specialist with regard to developing accounting estimates; (2) the use of information from third-party pricing services when evaluating estimates of fair value of financial instruments; and (3) using the work of an auditor's specialist. The effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2023. Future editions of the course will be updated for any new developments. Readers can follow this project at **www.aicpa.org**.

Proposed SAS, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations*. In February 2021, the AICPA issued an exposure draft of Proposed Statement on Auditing Standards

(SAS), *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations*. The proposed SAS would require the predecessor auditor to respond to inquiries from the auditor about identified or suspected fraud or noncompliance with laws or regulations (NOCLAR). The proposed SAS would continue to have management authorize the predecessor auditor to respond fully to the auditor's inquiries. The current tentative effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2022 with early implementation permitted. Any auditor changes during the calendar year 2022 would be subject to the changed requirements in this proposed SAS. Future editions of the course will be updated for any new developments. Readers can follow this project at **www.aicpa.org**.

Proposed SAS, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*. In February 2021, the AICPA issued an exposure draft of Proposed Statement on Auditing Standards (SAS), *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*. The proposed SAS reinforces that the engagement partner has overall responsibility for managing and achieving quality. Additionally, the proposed SAS focuses on how the engagement partner leverages the firm's system of quality management and how the engagement partner, at the engagement level, manages quality. The current tentative effective date, as proposed, would be for engagements conducted in accordance with generally accepted auditing standards for periods beginning on or after December 15, 2023. The Auditing Standards Board has also issued two proposed statements on quality management standards which address the firm's system of quality management. Future editions of the course will be updated for any new developments. Readers can follow this project at **www.aicpa.org**.

THE GOVERNMENTAL ACCOUNTING STANDARDS

Accounting Literature

Governmental entities are subject to generally accepted accounting principles (GAAP) for state and local governments. The Governmental Accounting Standards Board (GASB) is the official standards setting body for governmental GAAP. The following deal specifically with governmental accounting:

- GASB Statements of Governmental Accounting Standards and Interpretations deal with a variety of accounting and financial reporting issues and are enforceable under ET 1.320.001 of the AICPA's *Code of Professional Conduct*. GASBS No. 1 acknowledges the authoritative status of the GASB Codification.
- *Codification of Governmental Accounting and Financial Reporting Standards* of the Governmental Accounting Standards Board is an integration of currently effective accounting and reporting standards for state and local governmental units.
- AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), discusses existing accounting pronouncements and recognized practices unique to governmental units. It also gives guidance on applying GAAS to audits of state and local governmental financial statements.
- GASB Implementation Guides are issued by the GASB related to complex standards. The individual implementation guides are periodically incorporated into a Comprehensive Implementation Guide.
- GASB Technical Bulletins are released to selected knowledgeable persons for comment before being issued by a majority vote of the GASB. Technical Bulletins are not exposed for public comment like GASB Standards.

Literature issued by the AICPA and cleared by the GASB is also considered authoritative GAAP. SLG is a primary example. The governmental GAAP hierarchy is discussed in detail later in this section.

The Governmental Accounting Standards Board

Governmental entities are subject to generally accepted accounting principles (GAAP) for state and local governments. The Governmental Accounting Standards Board (GASB) is recognized by the AICPA as the primary standards setting body for governmental GAAP. The GASB is a seven-member board that operates much like the Financial Accounting Standards Board (FASB) and issues similar types of authoritative pronouncements.

The GASB's first authoritative pronouncement was GASBS No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*. This Statement recognizes the NCGA Statements and Interpretations and the accounting guidance in the 1974 AICPA Industry Audit Guide on governmental units and related SOPs as being encompassed within GAAP for governmental units. GASBS No. 1 continues those standards in force until they are superseded by future GASB pronouncements, and they have been incorporated in the GASB *Codification of Governmental Accounting and Financial Reporting Standards*. The GASB has issued pronouncements that supersede portions of previous authoritative standards. Each GASB Statement indicates what literature it supersedes, if any. Also, the GASB periodically updates the Codification to reflect current standards. The GASB's website address is **www.gasb.org**.

Statements of the Governmental Accounting Standards Board (GASBS). Exhibit 1-2 lists each Statement issued by the GASB as of the date this course went to press.

Exhibit 1-2

Statements of the Governmental Accounting Standards Board

GASBS No.	Title	Issue Date/ Superseded by
1	Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide	July 1984
2	Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457	Superseded by GASBS No. 32
3	Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements	April 1986
4	Applicability of FASB Statement No. 87, "Employers' Accounting for Pensions," to State and Local Governmental Employers	Superseded by GASBS No. 27
5	Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers	Superseded by GASBS Nos. 25 and 27
6	Accounting and Financial Reporting for Special Assessments	January 1987
7	Advance Refundings Resulting in Defeasance of Debt	March 1987
8	Applicability of FASB Statement No. 93, "Recognition of Depreciation by Not-for-Profit Organizations," to certain State and Local Governmental Entities	Superseded by GASBS No. 35
9	Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities that Use Proprietary Fund Accounting	September 1989
10	Accounting and Financial Reporting for Risk Financing and Related Insurance Issues	November 1989
11	Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements	Superseded by GASBS No. 34
12	Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers	May 1990
13	Accounting for Operating Leases with Scheduled Rent Increases	May 1990
14	The Financial Reporting Entity	June 1991
15	Governmental College and University Accounting and Financial Reporting Models	Superseded by GASBS No. 35
16	Accounting for Compensated Absences	November 1992

GASBS No.	Title	Issue Date/ Superseded by
17	Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements: Amendment of the Effective Dates of GASB Statement No. 11 and related Statements (an amendment of GASB Statement Nos. 10, 11, and 13)	June 1993
18	Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs	August 1993
19	Governmental College and University Omnibus Statement (an amendment of GASB Statement Nos. 10 and 15)	Superseded by GASBS No. 35
20	Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting	Superseded by GASBS No. 62
21	Accounting for Escheat Property	October 1993
22	Accounting for Taxpayer-Assessed Tax Revenues in Governmental Funds	Superseded by GASBS No. 33
23	Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities	December 1993
24	Accounting and Financial Reporting for Certain Grants and Other Financial Assistance	June 1994
25	Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans	Superseded by GASBS Nos. 67 and 73
26	Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans	Superseded by GASBS No. 43
27	Accounting for Pensions by State and Local Governmental Employers	Superseded by GASBS Nos. 68 and 73
28	Accounting and Financial Reporting for Securities Lending Transactions	May 1995
29	The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities	August 1995
30	Risk Financing Omnibus (an amendment of GASB Statement No. 10)	February 1996
31	Accounting and Financial Reporting for Certain Investments and for External Investment Pools	March 1997
32	Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans (a rescission of GASB Statement No. 2 and an amendment of GASB Statement No. 31)	October 1997
33	Accounting and Financial Reporting for Nonexchange Transactions	December 1998
34	Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments	June 1999
35	Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities (an amendment of GASB Statement No. 34)	November 1999
36	Recipient Reporting for Certain Shared Nonexchange Revenues (an amendment of GASB Statement No. 33)	April 2000

GASBS No.	Title	Issue Date/ Superseded by
37	Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus (an amendment of GASB Statement Nos. 21 and 34)	June 2001
38	Certain Financial Statement Note Disclosures	June 2001
39	Determining Whether Certain Organizations Are Component Units (an amendment of GASB Statement No. 14)	May 2002
40	Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)	March 2003
41	Budgetary Comparison Schedules—Perspective Differences (an amendment of GASB Statement No. 34)	May 2003
42	Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries	November 2003
43	Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans	Superseded by GASBS No. 74
44	Economic Condition Reporting: The Statistical Section (an amendment of NCGA Statement 1)	May 2004
45	Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions	Superseded by GASBS No. 75
46	Net Assets Restricted by Enabling Legislation (an amendment of GASB Statement No. 34)	December 2004
47	Accounting for Termination Benefits	June 2005
48	Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues	September 2006
49	Accounting and Financial Reporting for Pollution Remediation Obligations	November 2006
50	Pension Disclosures (an amendment of GASB Statement Nos. 25 and 27)	Superseded by GASBS Nos. 73 and 74
51	Accounting and Financial Reporting for Intangible Assets	June 2007
52	Land and Other Real Estate Held as Investments by Endowments	November 2007
53	Accounting and Financial Reporting for Derivative Instruments	June 2008
54	Fund Balance Reporting and Governmental Fund Type Definitions	February 2009
55	The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments	Superseded by GASBS No. 76
56	Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards	March 2009
57	OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans	Superseded by GASBS Nos. 74 and 75
58	Accounting and Financial Reporting for Chapter 9 Bankruptcies	December 2009
59	Financial Instruments Omnibus	June 2010
60	Accounting and Financial Reporting for Service Concession Arrangements	November 2010

GASBS No.	Title	Issue Date/ Superseded by
61	The Financial Reporting Entity: Omnibus, an amendment of GASB Statement Nos. 14 and 34	November 2010
62	Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements	December 2010
63	Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position	June 2011
64	Derivative Instruments: Application of Hedge Accounting Termination Provisions—an amendment of GASB Statement No. 53	June 2011
65	Items Previously Reported as Assets and Liabilities	March 2012
66	Technical Corrections—2012—an amendment of GASB Statement Nos. 10 and 62	March 2012
67	Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25	June 2012
68	Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27	June 2012
69	Government Combinations and Disposals of Government Operations	January 2013
70	Accounting and Financial Reporting for Nonexchange Financial Guarantees	April 2013
71	Pension Transition for Contributions Made Subsequent to the Measurement Date—an amendment of GASB Statement No. 68	November 2013
72	Fair Value Measurement and Application	February 2015
73	Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68	June 2015
74	Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans	June 2015
75	Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions	June 2015
76	The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments	June 2015
77	Tax Abatement Disclosures	August 2015
78	Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans	December 2015
79	Certain External Investment Pools and Pool Participants	December 2015
80	Blending Requirements for Certain Component Units	January 2016
81	Irrevocable Split-Interest Agreements	March 2016
82	Pension Issues—an amendment of GASB Statements No. 67, No. 68, and No. 73	March 2016
83	Certain Asset Retirement Obligations	November 2016
84	Fiduciary Activities	January 2017
85	Omnibus 2017	March 2017
86	Certain Debt Extinguishment Issues	May 2017

GASBS No.	Title	Issue Date/ Superseded by
87	Leases	June 2017
88	Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements	March 2018
89	Accounting for Interest Cost Incurred before the End of a Construction Period	June 2018
90	Majority Equity Interests—an amendment of GASB Statements No. 14 and No. 61	August 2018
91	Conduit Debt Obligations	August 2019
92	Omnibus 2020	January 2020
93	Replacement of Interbank Offered Rates	March 2020
94	Public-Private and Public-Public Partnerships and Availability Payment Arrangements	March 2020
95	Postponement of the Effective Dates of Certain Authoritative Guidance	May 2020
96	Subscription-Based Information Technology Arrangements	May 2020
97	Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans	June 2020

Authority of GASB Pronouncements. When the GASB was established, it was agreed that the GASB would establish standards for activities and transactions of state and local governmental entities, and the FASB would continue to establish accounting standards for all other entities. The Council of the AICPA designated the GASB as the body with the authority to establish accounting principles for state and local governmental entities in accordance with ET 1.320.001 of the *Code of Professional Conduct*. ET 1.320.001 provides that an auditor should not express an unmodified opinion if the financial statements or other financial data contain a material departure from an accounting principle promulgated by such a body unless, due to unusual circumstances, adherence to the principle would make the statements misleading. (Such departures are uncommon and ought to be undertaken only after extensive research and consideration.) The Council action gave GASB pronouncements an equivalent status to FASB pronouncements.

Authority and Hierarchy of GAAP for Governmental Entities. GASBS No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, categorizes authoritative GAAP as follows (descending order of authority):

- *Category A.* Officially established accounting principles—GASB Statements. All GASB Interpretations that were in effect when GASBS No. 76 was issued are included in this category until altered, amended, supplemented, revoked, or superseded. GASB Statements and Interpretations are periodically incorporated in the *Codification of Governmental Accounting and Financial Reporting Standards*.
- *Category B.* GASB Technical Bulletins, GASB Implementation Guides (incorporated periodically into the *Comprehensive Implementation Guide*), and AICPA literature specifically cleared by the GASB. (AICPA literature made applicable to governments contains a specific statement indicating it has been cleared by the GASB.)

When specific guidance is not available in category A, consideration should be given to whether category B contains an accounting principle that specifies the accounting treatment for the transaction or event. If it does, the governmental unit should follow the specified accounting treatment. If the accounting treatment is not specified by a pronouncement in category A or category B, consideration should be given first to accounting principles for similar transactions or events within category A or category B; then, the governmental unit may consider nonauthoritative accounting literature that does not conflict with or contradict authoritative GAAP.

Nonauthoritative Accounting Literature. GASBS No. 76, paragraph 7, indicates sources of nonauthoritative accounting literature include:

- GASB Concepts Statements.
- Pronouncements and other literature of the following:
  - FASB.
  - Federal Accounting Standards Advisory Board (FASAB).
  - International Public Sector Accounting Standards Board.
  - International Accounting Standards Board.
- AICPA literature not cleared by the GASB.
- Widely recognized and prevalent practices in state and local government.
- Literature published by other professional associations or regulatory agencies.
- Accounting textbooks, handbooks, and articles.

The GASB notes that the appropriateness of using nonauthoritative accounting literature depends on its consistency with GASB Concept Statements, the relevance to the specific circumstances, the specificity of its guidance, and the generally recognized authority of the literature's issuer or author.

Objectives of Governmental Accounting and Financial Reporting

The objectives of financial reporting for governmental units differ from those of business enterprises. The main objective of financial reporting for businesses is information about an enterprise's performance provided by measures of earnings. According to GASB Concepts Statement No. 1, the objectives of financial reporting for governmental units are to provide information to enable financial statement users to assess (a) the government's duty to be publicly accountable, (b) the governmental unit's operating results for the period, and (c) the level of services the governmental unit can provide and its ability to meet its obligations as they become due. Specific objectives include providing information to determine whether current year revenues are sufficient to pay for current year services and whether resources were obtained and used in accordance with the budget and other finance-related requirements. These differences in objectives lead to differences in financial measurement and presentation. The matching concept, which is important to accounting and income determination for business enterprises, does not have the same importance to governmental units. Governmental funds tend to emphasize the availability of liquid resources to pay current liabilities because governmental units levy taxes to pay for expected levels of service. For example, because depreciation is an expense that does not require the payment of a liability, including it in a governmental fund's operating statement does not provide useful information in assessing the fund's ability to pay its bills. Thus, the primary measurement focus for reporting governmental activities relates to the flow of current financial resources (cash and claims to cash) rather than the determination of net income.

As previously mentioned, governmental units are able to obtain resources from the populace on an individually involuntary basis. This means that governmental units typically have a significant stewardship responsibility to their resource providers. To meet that reporting responsibility, governmental units employ a system of budgetary and fund accounting to demonstrate compliance with laws and regulations that govern the expenditure of public resources.

Budgetary Accounting

Just as businesses do, governmental units use budgets to monitor revenues and control expenditures. However, the budget has much greater significance in the governmental sector. For one thing, most governmental units are required by law to have a budget and, once adopted, the budget usually has the force of law. Also, various aspects of the budget adoption process are usually specified in statutes, constitutional provisions, etc. The budget adoption process is highly political because the budget determines the allocation of resources to various programs. That is, the budget that the legislative authority (e.g., the city council or board of education) adopts determines the degree to which approved programs will be funded. Because the adopted budget is so important, governmental accounting systems and financial reporting are designed to facilitate and demonstrate adherence to the budget. One such means is fund accounting.

The Fund Structure

GASB Cod. Sec. 1100.102 defines a *fund* as follows:

> . . . a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

GASB Cod. Sec. 1300.101 gives the rationale for using fund accounting. It explains that the diversity of activities reported by governments and the need to show legal compliance makes it necessary for most governments to use several (and often many) separate funds, each reporting their own assets, deferred outflows of resources, liabilities, deferred inflows of resources, and equity. For this reason, from an accounting and reporting standpoint, each government is a combination of a broad variety of funds, each of which functions independently of the other funds and has a separate set of accounts.

There are several different categories and types of funds. GASB Cod. Sec. 1300.103 lists the following three fund categories, with eleven fund types within those categories:

a. Governmental fund category
   - (1) General fund.
   - (2) Special revenue funds.
   - (3) Capital projects funds.
   - (4) Debt service funds.
   - (5) Permanent funds.

b. Proprietary fund category
   - (1) Enterprise funds.
   - (2) Internal service funds.

c. Fiduciary fund category
   - (1) Pension (and other employee benefit) trust funds.
   - (2) Investment trust funds.
   - (3) Private-purpose trust funds.
   - (4) Custodial funds.

A governmental entity may have more than one fund in a fund type (for example, several special revenue funds), except that it usually has only one general fund. Exhibit 1-3 summarizes the fund categories and fund types and illustrates the types of transactions reported in each. The following paragraphs define these fund categories and fund types. The classification of funds by category and type is significant because different categories use different bases of accounting.

Exhibit 1-3

Governmental Fund Structure, Accounting, and Reporting

FUND CATEGORY	FUND TYPE	DEFINITION	EXAMPLE TRANSACTIONS		MEASUREMENT FOCUS	BASIS OF ACCOUNTING	FINANCIAL STATEMENTS REQUIRED
			REVENUE	EXPENDITURE/ EXPENSE			
Governmental	General	To account for and report all financial resources not accounted for and reported in another fund.	Sales taxes.	Police salaries.	Current financial resources flow (revenues and expenditures).	Modified accrual.	Governmental Fund Balance Sheet. Statement of Revenues, Expenditures, and Changes in Governmental Fund Balances.
	Special Revenue	To account for and report the proceeds of specific revenue sources that are *restricted* or *committed* for specified purposes other than debt service or capital projects.	Gasoline taxes restricted for a specific purpose.	Street and highway maintenance.			
	Capital Projects	To account for and report financial resources *restricted*, *committed*, or *assigned* to be used for capital outlays.	Bond proceeds.	Building construction.			
	Debt Service	To account for and report financial resources *restricted*, *committed*, or *assigned* to be used for principal and interest.	Property taxes committed to pay principal and interest.	Bond interest and principal repayment.			
	Permanent	To account for and report resources that are restricted such that the reporting government (or its citizens) is the beneficiary of the earnings on the principal.	Earnings on permanently restricted resources are used to finance expenditures of specific governmental programs, such as cemetery maintenance.				

FUND CATEGORY	FUND TYPE	DEFINITION	EXAMPLE TRANSACTIONS		MEASUREMENT FOCUS	BASIS OF ACCOUNTING	FINANCIAL STATEMENTS REQUIRED
			REVENUE	EXPENDITURE/ EXPENSE			
Proprietary	Enterprise	To account for activities in which a fee is charged to an external user for goods or services, if elected. Required to be used in three circumstances: when an activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; when laws or regulations require that the activity's costs of providing services be recovered with fees and charges; or when the activity's pricing policies establish fees and charges designed to recover its costs.	Electric utility bills.	Costs of providing electrical service.	Economic resources flow (revenues and expenses).	Accrual.	Statement of Net Position. Statement of Revenues, Expenses, and Changes in Fund Net Position. Statement of Cash Flows.
	Internal Service	To account for the financing of goods or services provided by one department or unit to another department or to other governmental units on a cost reimbursement basis.	Computer time charges.	Expenses of operating data processing center.			
Fiduciary	Pension Trust	Pension and other employee benefit plans administered by a government.	Employer and employee contributions.	Benefits.	Economic resources flow (revenues and expenses).	Accrual (except for recognition of certain liabilities of defined benefit pension plans and certain post-employment healthcare plans).	Statement of Fiduciary Net Position. Statement of Changes in Fiduciary Net Position.
	Investment Trust	External portion of investment pools held by sponsoring government.	Investment income.	Administrative expenses.			
	Private-purpose	To account for trust arrangements under which principal or interest benefit specific individuals, private organizations, or other governments—but not the reporting government.	Trust income (and expense) that benefit individuals, private organizations, or other governments.				
	Custodial	Fiduciary activities not reported in other fiduciary funds.	Property taxes collected for other governments	Property taxes distributed to other governments			

Governmental Category Funds

Governmental category funds are used to account for the activities one thinks of as typical functions of government. Police and fire protection, road and street construction and repair, and social services are examples of activities that are accounted for in governmental category funds. The common characteristic of these services is that citizens receive them without directly paying for their cost. For example, the police department does not usually charge a fee for coming to the scene of a crime or for the related investigation. Such services are usually thought of as a right of citizenship. Consequently, there is no attempt to match the cost of the service with the revenues that support it when making pricing decisions or performance evaluations as is the case with profit-seeking entities. The primary focus of financial reporting for governmental category funds is on the flow of current financial resources and on the budgets that provide control over the expenditures. Governmental category resources are obtained from various taxes, grants, and assessments. Laws generally place limits on what projects or activities the resources may be used to support. For example, property taxes may be limited to the support of secondary education.

There are five governmental fund types in the governmental category:

a. The *general fund* accounts for and reports all financial resources except those accounted for and reported in other funds. A governmental unit reports just one general fund.

b. *Special revenue funds* account for and report the proceeds of specific revenue sources that are *restricted* or *committed* for specified purposes other than debt service or capital projects. A special revenue fund should not be reported unless its foundation is one or more specific restricted or committed revenues.

c. *Capital projects funds* account for and report financial resources *restricted*, *committed*, or *assigned* to be expended for capital outlay. For example, a capital project fund would account for the proceeds of bonds sold to provide funds for building schools.

d. *Debt service funds* account for and report financial resources *restricted*, *committed*, or *assigned* to be expended for principal and interest.

e. *Permanent funds* account for and report resources that are restricted to allow the earnings (and not principal) to be used to support the government's programs, such as cemeteries, libraries, parks, or scholarships.

Modified Accrual Basis of Accounting for Governmental Funds. The modified accrual basis of accounting is used for governmental funds because the profit motive is generally absent from the conduct of governmental fund type activities and because of the budgetary restrictions on governmental fund expenditures. Under the modified accrual basis of accounting, the focus is on sources, uses, and balances of fund current financial resources. Thus, balance sheets of governmental fund types report only expendable resources (i.e., resources that are, or will become, available to pay obligations of the governmental unit), related current liabilities, and resulting fund equity. The operating statements present revenues and expenditures; i.e., decreases in net financial resources (not expenses). For example, the repayment of debt is an expenditure but not an expense. Conversely, depreciation is an expense but not an expenditure. In sum, an expenditure is a use of financial resources, and an expense is commonly described as an expired cost. Thus, the acquisition of a capital asset is an expenditure but not an expense. Expenditures, rather than expenses, are reported because the financial reporting objectives of governmental funds relate to demonstrating compliance with spending restrictions and to presenting the results of *financial* operations. Thus, such common expenses as depreciation or bond discount amortization are not reported in governmental funds' operating statements.

Revenues. In governmental fund accounting, the term *revenues* means increases in (sources of) fund financial resources other than from interfund transfers and debt issue proceeds. Revenues are recognized in governmental type funds when they become available and measurable. *Available* means that the revenues will be collected during the year or soon enough after year-end to pay liabilities arising from operations of the year just ended. When resources are recorded but the revenue does not meet the availability criterion, a deferred inflow of resources should be reported until the revenue becomes available.

GASB Cod. Sec. 1600.107 explains that some revenues are assessed and collected in such a manner that they can appropriately be accrued, whereas others cannot. Revenues and deferred inflows of resources that usually can and should be recorded under the modified accrual basis of accounting include property taxes, regularly billed charges for inspection or other routinely provided services, most grants from other governments, interfund transfers and other transactions, and sales and income taxes where taxpayer liability has been established and collectibility is assured or losses can be reasonably estimated.

Expenditures. Expenditures generally are recognized in governmental funds when the related liabilities are incurred. A governmental unit might incur a long-term liability for a current cost such as pensions or compensated absences. In that case, only the currently payable portion of the long-term liability is reported in a governmental fund; the noncurrent portion is reported as a governmental activity in the government-wide statement of net assets. As a result, the fund's equity is only reduced by the currently payable portion of the liability.

Capital Assets. A governmental fund cannot use capital assets to satisfy fund liabilities. Therefore, most noncurrent assets are not reported in governmental funds but are reported as a governmental activity in the government-wide statement of net position. Similarly, depreciation expense does not represent a use of an expendable resource; thus, depreciation is not recorded on capital assets in the governmental funds financial statements.

Long-term Debt. Long-term liabilities will be repaid with resources becoming available in future periods. Thus, noncurrent debt is excluded from governmental funds and is reported as a governmental activity in the government-wide statement of net assets.

Deferred Outflows of Resources and Deferred Inflows of Resources. Deferred outflows of resources is a financial statement element that represents the consumption of net assets applicable to a future period and are reported in a separate section following assets. Deferred inflows of resources is a financial statement element that represents the acquisition of net assets applicable to a future period and are reported in a separate section following liabilities.

Proprietary Category Funds

Proprietary category funds are used to account for and report those activities that are designed to be self-supporting from fees charged to consumers of the funds' goods and services or where the governing body has decided that the periodic determination of revenues, expenses, and net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. The accounting and financial reporting practices of proprietary funds are similar to those used for business enterprises and focus on capital maintenance and the flow of economic resources. That is, revenues are matched with expenses, and net income is determined using accrual accounting methods. For example, capital assets are depreciated, and related depreciation expense is allocated over the assets' useful lives. Also, long-term debt is included in proprietary funds statements of net position. In summary, many of the normal financial accounting practices used for business enterprises are used to account for proprietary fund activities.

As discussed in the previous paragraph, accounting for and presentation of activities and balances of proprietary funds is similar to that of business enterprises as the activities and transactions resulting in proprietary funds are generally exchange transactions in which citizens of a government benefit from goods or services provided by the government in exchange for fees. However, in certain situations, deferred outflows of resources and deferred inflows of resources are to be reported in the statement of net position.

Two fund types are included in the proprietary fund category: enterprise and internal service funds.

- *Enterprise funds* may be used to account for any activity in which a fee is charged to an external user for goods or services. However, they must be used to account for activities (a) that are financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity, (b) when laws or regulations require that the activity's costs of providing services, including capital costs, such as depreciation or debt service, be recovered with fees and charges (not taxes), or (c) the pricing policies of the activity establish fees and charges designed to recover its costs. Examples of activities conducted by proprietary category funds include water, electric, and gas utilities, hospitals, airports, toll roads and bridges, and harbors. Such operations are financed and operated in a manner similar to private businesses and are intended to be self-supporting through charges to users.

- *Internal service funds* account for the financing of goods or services provided by one governmental department or agency to another on a cost-reimbursement basis. Examples of such operations include computer centers, vehicle pools, and supply centers. As with enterprise funds, internal service funds are expected to be self-supporting through charges to users.

Fiduciary Category Funds

The fiduciary funds category consists of the following fund types:

- *Pension (and other employee benefit) trust funds* typically account for a government's single-employer public employee retirement plan, other postemployment benefit plan, or other employee benefit plan.

- *Investment trust funds* account for the external portion of a sponsoring governmental unit's investment pool.

- *Private-purpose trust funds* account for trust arrangements under which principal and income benefit individuals, private organizations, or other governments, such as escheat property held in trust for the benefit of individuals or other governments.

- *Custodial funds* account for fiduciary activities that are not required to be reported in the other fiduciary fund types [i.e., pension (and other employee benefit) trust funds, investment trust funds, private-purpose trust funds]. The external portion of an investment pool that is not held in a qualifying trust should be reported in a separate internal investment pool column classified as a custodial fund.

GASB Cod. Sec. 1600 explains that, except for the recognition of certain liabilities of defined benefit pension plans and other postemployment benefit plans, fiduciary funds are accounted for on the accrual basis of accounting.

In certain situations, deferred outflows of resources and deferred inflows of resources are to be reported in the fiduciary fund statement of net position.

Fiduciary Activities. GASBS No. 84, *Fiduciary Activities*, as amended, establishes general criteria for determining when a governmental unit has a fiduciary role for managing certain types of assets. The focus of the criteria generally is on (a) whether the government controls the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists. As discussed above, there are four types of fiduciary funds. A statement of changes in fiduciary net position is required for all fiduciary funds, including custodial funds. GASBS No. 84 also requires fiduciary funds to recognize a liability to the beneficiaries when an event has occurred that compels the government to disburse fiduciary resources. Compelling events occur when a demand for the resources has been made or when no further action, approval, or condition is required to be taken or met by the beneficiary to release the assets.

In June 2020, GASBS No. 97, *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, was issued, which replaces the reporting guidance in GASBS No. 32. Since GASBS No. 84 also included component unit guidance for pension and OPEB plans, GASBS No. 97 also includes a modification to that guidance. GASBS No. 97 amends GASBS No. 84, paragraph 7, to clarify that the component unit discussion for pension and OPEB plans only applies to defined benefit plans. Effectively, this excludes deferred compensation plans from the component unit analysis required by GASBS No. 14, as amended. This particular change was effective June 2020, but the remainder of GASBS No. 97 is not effective until fiscal years beginning after June 15, 2021.

Identifying Fiduciary Activities. According to GASBS No. 84, paragraph 5, there are several ways in which a government or its component units might be engaged in fiduciary activities, if they meet certain criteria. Activities that may be classified as fiduciary activities may stem from (a) a component unit (a *fiduciary component unit*), (b) pensions and OPEB arrangements that are not component units, and (c) other fiduciary activities.

A legally separate entity that meets the component unit criteria in GASBS No. 14, as amended, is engaged in a fiduciary activity if it is one of the following arrangements:

a. A pension or OPEB plan that is administered through a qualifying trust (i.e., meets specified criteria in GASBS Nos. 67 or 74).

b. Assets associated with the component unit are accumulated from entities (that are not part of the primary government) for pensions or OPEB not administered through a qualifying trust (i.e., meets specified criteria in GASBS Nos. 73 or 74).

c. The assets associated with the component unit's activity have at least one of the following characteristics:

- The assets are administered through a trust committed to providing benefits to recipients. The government is not a beneficiary of the trust, and the assets are protected from the government's creditors.
- The assets are for the benefit of individuals, and the government does not have administrative or direct financial involvement with the assets nor are the assets derived from the government providing goods or services to those individuals.
- The assets are for the benefit of other entities (not part of the financial reporting entity) and are not derived from the government providing goods or services to those entities.

Pensions and OPEB arrangements that are not component units are considered a fiduciary activity if it is an arrangement described in a. or b. above.

Other fiduciary activities include those that meet *all* of the following criteria:

- Assets associated with the activity are controlled by the government
- Assets associated with the activity are *not* derived solely from the government's own-source revenues or from government-mandated nonexchange transactions or voluntary nonexchange transactions. Pass-through grants are exceptions from the latter criteria if the government does not have administrative or direct financial involvement.
- Assets associated with the activity have at least one of the characteristics listed in item c. above.

PPC's Guide to Audits of Local Governments includes a practice aid that helps auditors identify whether an activity is a fiduciary activity in accordance with GASBS No. 84, as amended, and, if so, in which fiduciary fund-type the activity should be recorded. GASB's Implementation Guide No. 2019-2, *Fiduciary Activities*, may also be useful to practitioners in identifying, accounting for, and reporting fiduciary activities.

Scope of Government-wide Reporting

The activities of a general-purpose government can be categorized into the following three types of activities:

- *Governmental activities* generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues. Examples include fire and police services. Governmental activities are usually reported in governmental funds and internal service funds in the fund financial statements.
- *Business-type activities* are financed in whole or in part by fees charged to those external parties who use the goods or services. Examples include water sales and golf course green fees. Business-type activities are usually reported in enterprise funds in the fund financial statements.
- *Fiduciary activities* involve holding and managing assets for specific individuals or other external parties in accordance with trust agreements or other custodial arrangements. Examples include the net position of external participants in government-sponsored investment pools and the net position of pension plans and other employee benefit plans, held in trust for a government's employees. Fiduciary activities are reported in trust and agency funds (custodial funds after implementation of GASBS No. 84) in the fund financial statements.

In accordance with GASBS No. 34, Paragraph 13, the government-wide statements report only the *governmental activities* and *business-type activities* of the primary government (including blended component units) and any discretely presented component units that report governmental or business-type activities. The government-wide statements *exclude* any *fiduciary activities* or component units that are fiduciary in nature (fiduciary component units). The government-wide financial statements should be prepared using the economic resources measurement basis and the full accrual basis of accounting.

The Financial Reporting Entity

In the audit of a governmental unit, a significant consideration is what activities should be included in the financial statements. The question arises because governmental units, including small local ones, frequently conduct some of their activities through, or are otherwise related to, other organizations. For example, a city may own and operate a water utility. The water utility may operate rather independently; for example, it may have a governing body separate from the city's, and it may keep its own set of accounting records. Under GAAP, however, the operating activities, assets, and liabilities of the water utility should be combined with other components to form a governmental financial reporting entity if certain criteria are met.

GASBS No. 14, as amended, establishes standards for determining which organizations should be included in the financial reporting entity and for reporting the financial information of those organizations.

Definition. GASBS No. 14, as amended, defines the *governmental financial reporting entity* as being made up of two parts:

- The primary government (PG), such as—
  - A state government or general purpose local government (municipality or county).
  - A special purpose state or local government (e.g., school district, park district) that has a separately elected governing body, is legally separate, and is fiscally independent of other governments.
  - The primary government includes all of its funds, organizations, agencies, departments, institutions, and offices that make up the legal entity.
- *Component units* (CUs), which are defined as—
  - Units for which the PG is financially accountable (financial accountability is discussed in detail in *PPC's Guide to Preparing Governmental Financial Statements*).
  - Units for which the PG owns a majority of the equity interest (and after implementation of GASBS No. 90, the interest does not meet the definition of an investment). After GASBS No. 90, a majority equity interest in another entity that meets the definition of an investment is reported as an investment and not a CU.
  - Units that must be included to keep the financial statements from being misleading because of the nature or significance of their relationships with the primary government.

Financial Reporting. Financial reporting should present an overview yet allow users to distinguish between the PG and its component units. There are three types of component units: discretely presented, blended, and fiduciary. Discrete presentation means that data will be presented in one or more separate columns to the right of the PG data columns. Additional information about major component units and nonmajor component units in the aggregate should be presented in either combining statements or in condensed financial statements in the notes.

For those nonfiduciary component units that are so closely related to the PG that they are, in effect, the same as the primary government, GASBS No. 14 requires that the blending method be used. Blending means that the component unit's financial data is reported as though the unit is part of the PG. Each fund of a blended CU should be reported as if it were a fund of the same type of the PG—special revenue funds as special revenue funds, enterprise funds as enterprise funds, and so forth. There is a single exception to this rule. GASBS No. 14, paragraph 54, states that because GAAP allows a government to report only one general fund, the general fund of a blended CU should be reclassified as a special revenue fund. Blended governmental or enterprise funds that meet the definition of a major fund should be reported in a separate column in the appropriate set of fund financial statements.

Fiduciary CUs (including their own fiduciary CUs) are combined with the fiduciary funds of the PG and presented in aggregate based on the classification of the fiduciary fund type. Each fiduciary fund type is presented in a separate column in the fiduciary fund financial statements.

Blended Component Units. GASBS No. 14, paragraph 53, as amended, requires blending when one of the following circumstances is met:

a. There is substantively the same governing body for both the PG and the CU—e.g., a school board (the PG) that also serves as the board of a school building authority (the CU)—and one of the following criteria also is met:

   (1) there is a financial benefit or burden relationship between the primary government and the component unit, or

   (2) the operational responsibility for the component unit rests with the management of the primary government. (The term *management of the primary government* refers to personnel below the level of the governing board, such as a county executive or city manager. The term *operational responsibility* means that the primary government manages the component unit in essentially the same manner as it manages its own programs, activities, agencies, or departments.)

b. A CU provides services entirely (or almost entirely) to the PG or benefits the PG exclusively (or almost exclusively). Examples include a building authority, a computing services entity, a captive self-insurance company, or a benefits administration entity. However, benefits provided by the CU to citizens of the PG (for example, a parking garage) are not considered benefits to the PG.

c. A CU's debt, including leases, is expected to be repaid entirely or almost entirely with the primary government's resources. Repayment generally consists of the PG making a pledge or continuing appropriation to cover debt service, which the CU, in turn, pledges as the primary source or security for repayment of the debt. This criterion applies to CUs that provide services to others as well as to financing entities.

d. The component unit is organized as a not-for-profit corporation in which the primary government is identified in the articles of incorporation or bylaws as the sole corporate member. (This blending requirement, which was established by GASBS No. 80, only applies if the not-for-profit entity meets the GASBS No. 14 criteria for being included in the reporting entity.)

For a government that reports only business-type activity or business-type and fiduciary activities in a single column financial statement GASBS No. 85, *Omnibus 2017*, clarifies that component units can only be blended into that column if they meet the criteria for blending described in items a through d.

Discretely Presented Component Units. All nonfiduciary component units that do not meet the criteria for blending should be reported by discrete presentation in the PG's government-wide financial statements. Discrete presentation requires reporting CU financial data in columns and rows separate from the financial data of the PG. GASBS No. 14, as amended, also requires information about each major discretely presented CU to be provided in the basic financial statements of the reporting entity. GASBS No. 14, paragraph 51, as amended by GASBS No. 61, discusses identifying "major" discretely presented component units. Consideration should be given to a CU's nature and significance in comparison to the PG generally based on any of the following three factors:

a. the CU provides services to the citizenry that make separate reporting as a major component unit essential to financial statement users,

b. the CU has significant transactions with the primary government, or

c. the CU has a significant financial benefit or burden relationship with the primary government.

Consistent with all other GASB pronouncements, the term "significant" is not defined or illustrated.

Notes to the Financial Statements. The notes to the financial statements should be segregated between the information pertaining to the PG (including its blended component units) and its discretely presented CUs. Also, the GAAP disclosures found in the *Codification*, Section 2300, are applicable to PGs and their blended CUs.

Other Reporting Relationships. GASBS No. 14 also includes guidance on related organizations, joint ventures, jointly governed organizations, and undivided interests. Additional information on these and other reporting entity topics can be found in *PPC's Guide to Preparing Governmental Financial Statements*.

GASB Concepts Statements

The GASB issues Concepts Statements (CSs) to provide a conceptual foundation that can be applied to address financial reporting issues. Concepts Statements are nonauthoritative and do not establish GAAP; however, they can be used to gain a better understanding of the fundamental concepts underlying the GASB's financial reporting standards.

Concepts Statement on Service Efforts and Accomplishments. GASBCS No. 2, as amended by GASBCS No. 5, establishes a broad framework for the GASB to use when considering standards for reporting service efforts and accomplishments (SEA). The Statement provides a rationale for the objective of SEA reporting and identifies the reporting elements and the qualitative characteristics that SEA performance information should possess. However, the Statement does not establish any SEA measurement or reporting requirements.

GASBCS No. 2, as amended, explains that SEA reporting is an important part of general purpose external financial reporting, which focuses on providing information to meet the needs of external users. GASBCS No. 2, as amended, further explains that SEA performance measurement and reporting should occur for services that the governmental unit is responsible for providing, regardless of whether the services are provided by the governmental unit itself or by others, such as volunteers or contractors. The three elements of SEA performance measures and related information provide a framework for understanding and assessing results and are important aspects of SEA reporting. Those three elements are—

a. Measures of service efforts (i.e., the amount of financial and nonfinancial resources that are applied to a service).

b. Measures of service accomplishments (i.e., what was provided and achieved with the resources used).

c. Measures that relate service efforts to service accomplishments (i.e., the relationship of service efforts to service outputs, such as the cost per lane-mile of road maintained; or the relationship of service efforts to service outcomes or results, such as the cost per lane-mile of road maintained in good or excellent condition).

GASBCS No. 2, as amended, clarifies that it is beyond the scope of the GASB to establish the goals and objectives of state and local government services, develop specific nonfinancial measures or indicators of service performance, or establish benchmarks for service performance.

The government-wide financial statements provide a basis for reporting SEA. GASB Statement No. 34, Appendix B, paragraph 234, points out that the government-wide financial statements should contribute towards achieving the SEA objectives of operational accountability, economy, and efficiency. Nonfinancial information is not provided in the government-wide financial statements, but a link is provided between the financial statements and SEA reporting.

Concepts Statement on Communication Methods. GASBCS No. 3 provides a basis for determining where information should be reported in general purpose external financial reports. GASBCS No. 3 states that certain information is better provided outside the financial statements.

GASBCS No. 3 lists the following four methods that can be used to communicate information in general purpose external financial reports that include basic financial statements:

- Recognition in the basic financial statements.
- Disclosure in the notes to the basic financial statements.
- Presentation as required supplementary information (RSI).
- Presentation as supplementary information (SI).

When the GASB deliberates how new GAAP information should be communicated, it will begin by determining whether the information meets the definition and criteria for recognition in the basic financial statements. If the information does not meet those tests, disclosure in the notes to the basic financial statements will be considered next, and so forth. The converse is also true. For example, RSI is not an adequate substitute for communicating information that meets the definition and criteria for communication in the notes to the basic financial statements.

Concepts Statement on Elements of Financial Statements. GASBCS No. 4 establishes definitions for seven elements that are the fundamental components of governmental financial statements. Accounts included in financial statements, such as cash, accounts payable, tax revenues, etc., are reported within the broad categories of elements. The concept of a *resource* is central to the definitions of elements. A *resource* is an item with present capacity to provide services to the government's citizens. Resources can either flow to the government or from the government.

The elements of a statement of financial position are—

- *Assets.* Assets represent resources with present service capacity that the government presently controls.
- *Deferred Outflows of Resources.* A deferred outflow of resources is a consumption of net assets by the government that is applicable to a future reporting period.
- *Liabilities.* Liabilities represent present obligations to sacrifice resources that the government has little or no discretion to avoid.
- *Deferred Inflows of Resources.* A deferred inflow of resources is an acquisition of net assets by the government that is applicable to a future reporting period.
- *Net Position.* Net position represents the residual of all other elements presented in a statement of financial position. (In this course, the authors also use the term *equity* to refer to net position.)

The elements of a resource flows statement (i.e., an operating statement) are—

- *Outflows of Resources.* An outflow of resources is a consumption of net assets by the government that is applicable to the reporting period.
- *Inflows of Resources.* An inflow of resources is an acquisition of net assets by the government that is applicable to the reporting period.

Concepts Statement on Measurement of Elements of Financial Statements. GASBCS No. 6 provides a basis for the measurement of certain financial statement elements, focusing on assets and liabilities. GASBCS No. 6 does not establish a basis for measurement of inflows, outflows, or deferred inflows or outflows of resources because those elements relate to, or are derived from, assets and liabilities. Similarly, net position is the residual of the other elements in the statement of net position.

GASBCS No. 6 defines the term *measurement* as the act or process of determining a value for financial statement elements. It establishes two measurement approaches and four measurement attributes.

The measurement approach used depends on the point in time an amount is reported for an element. The *initial-transaction-date-based measurement* (initial amount) is the transaction price or amount assigned to an asset or liability at the acquisition date, and includes subsequent modifications that are derived from the amount originally reported, such as depreciation or impairment. The *current-financial-statement-date-based measurement* (remeasured amount) is the amount assigned to an asset or liability when an element is remeasured as of the financial statement date.

Various measurement attributes may be used when applying a measurement approach, including—

- *Historical cost.* The price paid in acquiring an asset or amount received when incurring a liability during an exchange transaction. Historical cost is an entry price that may only be used for initial amounts.

- *Fair value.* The price that would be received for the sale of an asset or paid for the transfer of a liability at the measurement date. Fair value assumes an orderly transaction between market participants in either the principal or most advantageous market. Fair value is an exit price and may be used for initial amounts or remeasured amounts.
- *Replacement cost.* The price that would be paid for an equivalent asset in an orderly transaction at the measurement date. Replacement cost is an entry price that is typically only appropriate for assets and may be used for initial amounts or remeasured amounts.
- *Settlement amount.* The amount that could be realized for an asset or at which a liability could be liquidated. Settlement amount generally requires a counterparty and involves a market that is not active. This attribute may be used for initial amounts or remeasured amounts.

SELF-STUDY QUIZ

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

1. All of the following entities would be considered a *governmental organization* **except**:
   a. A body politic.
   b. An entity with officers elected by popular vote.
   c. An entity that can issue tax-exempt debt through a municipal authority.
   d. An entity that can be unilaterally dissolved by a government that keeps its assets.
2. What part of an auditing standard helps auditors understand what they should achieve under that standard?
   a. The introduction.
   b. The definitions.
   c. The objectives.
   d. The requirements.
3. One of the objectives of the quality control auditing standard (AU-C 220B), is that the auditor implements quality control procedures at the engagement level that provide reasonable assurance that which occurs?
   a. The audit complies with professional standards and legal and regulatory requirements.
   b. The auditor obtains reasonable assurance about whether the financial statements are free from misstatement.
   c. The auditor reports on the financial statements in accordance with his or her findings.
   d. The auditor is independent from the entity being audited under all circumstances.
4. Which of the following guidance issued by the Governmental Accounting Standards Board (GASB) relates to complex standards?
   a. The *Codification of Governmental Accounting and Financial Reporting Standards.*
   b. GASB Implementation Guides.
   c. GASB Statements of Governmental Auditing Standards and Interpretations.
   d. GASB Technical Bulletins.
5. Which of the following is a characteristic of a special purpose primary government?
   a. It must be included in the financial statements to keep them from being misleading.
   b. It is considered either municipality or a county government.
   c. It is legally separate and has a separately elected governing body.
   d. It is financially accountable to another entity.

SELF-STUDY ANSWERS

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

1. All of the following entities would be considered a *governmental organization* **except: (Page 151)**

   a. A body politic. [This answer is incorrect. According to paragraph 1.01 of the AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), all public corporations and bodies corporate and politic are considered governmental organizations.]

   b. An entity with officers elected by popular vote. [This answer is incorrect. Per paragraph 1.01 of SLG, organizations with officers elected by popular vote or for which a controlling majority of officers are appointed by officials of one or more state governments are considered governmental organizations.]

   c. **An entity that can issue tax-exempt debt through a municipal authority. [This answer is correct. Organizations are presumed to be governmental if they can *directly* issue tax-exempt debt, that is, *not* issue it through a state or municipal authority. However, the government may rebut that presumption if none of the other governmental characteristics listed in paragraph 1.01 of SLG apply and compelling, relevant evidence exists that the organization should not be considered governmental.]**

   d. An entity that can be unilaterally dissolved by a government that keeps its assets. [This answer is incorrect. If a government can unilaterally dissolve an organization and retain the organization's remaining net assets, it is considered a governmental organization under paragraph 1.01 of SLG.]

2. What part of an auditing standard helps auditors understand what they should achieve under that standard? **(Page 154)**

   a. The introduction. [This answer is incorrect. The introduction of a standard includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material. It does not serve the purpose described above.]

   b. The definitions. [This answer is incorrect. The definitions section of a standard provides key definitions that are relevant to that standard. This section does not achieve the goal described above.]

   c. **The objectives. [This answer is correct. Each auditing standard is divided into five topics. One of those topics is the objectives. This topic establishes objectives that allow the auditor to understand what he or she should achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.]**

   d. The requirements. [This answer is incorrect. This portion of the standard states the requirements that the auditor is to follow to achieve certain objectives unless the standards is not relevant, or the requirement is conditional and the condition does not exist. This information is more specific than that required for the purpose discussed above.]

3. One of the objectives of the quality control auditing standard (AU-C 220B), is that the auditor implements quality control procedures at the engagement level that provide reasonable assurance that which occurs? **(Page 156)**

   a. **The audit complies with professional standards and legal and regulatory requirements. [This answer is correct. AU-C 220B, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards,* provides requirements and other explanatory material to the auditor and engagement partner as they implement each element of quality control during the performance of an audit of the financial statements. The objective is for the auditor to implement quality control procedures at the engagement level that provide reasonable assurance that (1) the audit complies with professional standards and applicable legal and**

regulatory requirements and (2) in the circumstances, the auditor's report issued is appropriate.]

b. The auditor obtains reasonable assurance about whether the financial statements are free from misstatement. [This answer is incorrect. This is one of the overall objectives of the auditor in conducting an audit of the financial statements, per AU-C 200B, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards,* which is a different standard.]

c. The auditor reports on the financial statements in accordance with his or her findings. [This answer is incorrect. One of the overall objectives of an audit of financial statements discussed in AU-C 200B (which is a different standard) is that, in accordance with the auditor's findings, the auditor (1) reports on the financial statements and (2) makes the communications required by generally accepted auditing standards (GAAS).]

d. The auditor is independent from the entity being audited under all circumstances. [This answer is incorrect. AU-C 200B.15, which is a different standard, states that the auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (1) GAAS provides otherwise or (2) law or regulation requires accepting the engagement and reporting on the financial statements. Therefore, (1) this is not an objective included in AU-C 220B and (2) there are certain limited circumstances in which a lack of independence is allowed.]

4. Which of the following guidance issued by the Governmental Accounting Standards Board (GASB) relates to complex standards? **(Page 162)**

a. The *Codification of Governmental Accounting and Financial Reporting Standards*. [This answer is incorrect. This is an integration of currently effective accounting and reporting standards for state and local government audits.]

b. **GASB Implementation Guides. [This answer is correct. GASB is the official standards setting body for governmental GAAP. Among other things, it releases GASB Implementation Guides. These are issued by the GASB in relation to complex standards. The individual implementation guides are periodically incorporated into a Comprehensive Implementation Guide.]**

c. GASB Statements of Governmental Auditing Standards and Interpretations. [This answer is incorrect. These deal with a variety of accounting and financial reporting issues and are enforceable under ET 1.320.001 of the AICPA's *Code of Professional Conduct*. GASBS No. 1 acknowledges the authoritative status of the GASB Codification.]

d. GASB Technical Bulletins. [This answer is incorrect. These are released to selected knowledgeable persons for comment before being issued by a majority vote of the GASB. Technical Bulletins are not exposed for public comment like GASB Standards.]

5. Which of the following is a characteristic of a special purpose primary government? **(Page 176)**

a. It must be included in the financial statements to keep them from being misleading. [This answer is incorrect. One of the characteristics that indicates an entity is a component unit and not a primary government is when it must be included in a primary government's financial statements to keep them from being misleading because of the nature and significance of their relationships with that primary government.]

b. It is considered either municipality or a county government. [This answer is incorrect. A state government or a general purpose local government (municipality or county) is considered a primary government; however, a special purpose primary government has different characteristics.]

c. **It is legally separate and has a separately elected governing body. [This answer is correct. According to GASBS No. 14, a special purpose state or local government (e.g., school district, park district) has, among other things, a separately elected governing body and is legally separate.]**

d. It is financially accountable to another entity. [This answer is incorrect. A special purpose primary government is fiscally independent of other governments. A component unit, on the other hand, is a unit for which the primary government is financially accountable.]

THE BASICS OF GOVERNMENTAL FINANCIAL STATEMENTS

This section summarizes certain GASB financial reporting requirements for governmental entities. *PPC's Guide to Preparing Governmental Financial Statements* contains detailed guidance on preparing financial statements in accordance with GAAP. *PPC's Governmental Financial Statements Illustrations and Trends* provides actual government-wide and fund financial statements, notes, management discussion and analysis, and required supplementary information (RSI) for various types and sizes of governmental units.

This section provides a basic understanding of the governmental financial reporting model established by GASBS No. 34, as amended. Its minimum reporting requirements are discussed below.

Minimum Reporting Requirements

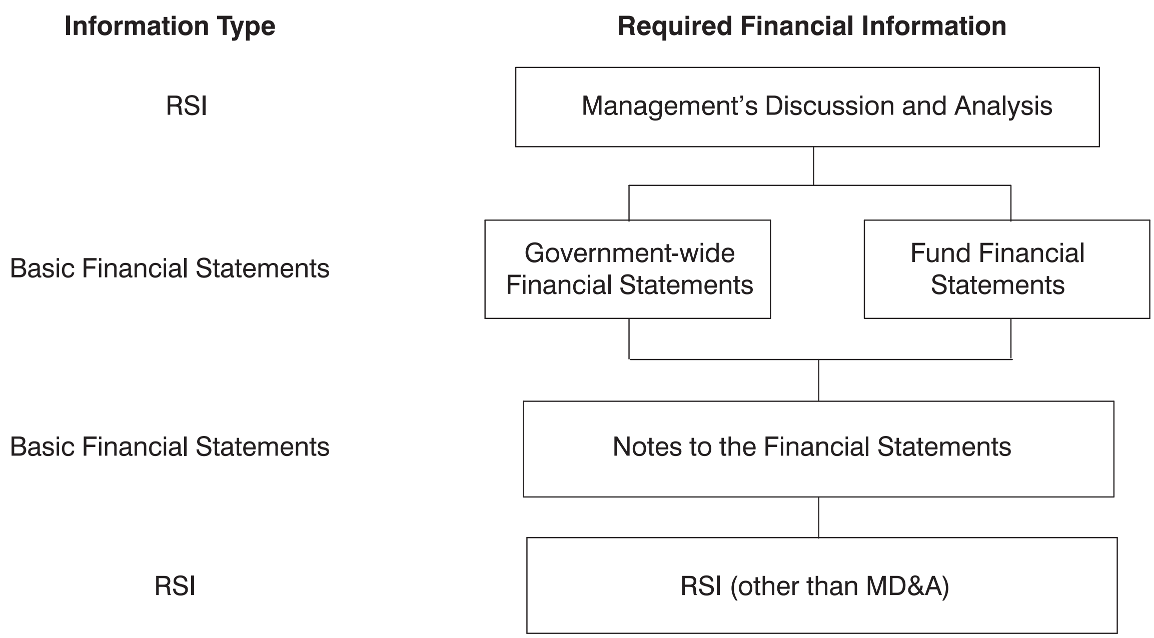
General purpose governments must present the following basic financial statements and required supplementary information (RSI):

- Management's discussion and analysis (MD&A).
- Basic financial statements—
  - Government-wide financial statements.
  - Fund financial statements.
  - Notes to the financial statements.
- RSI, including budgetary comparison schedules, infrastructure condition data, and data required by other GASB pronouncements, if applicable.

The MD&A and RSI, though not part of the basic financial statements, are required for all governments. Exhibit 1-4 illustrates this information graphically. Each of these topics is discussed in the following paragraphs.

Exhibit 1-4

Minimum Financial Reporting Requirements



Management's Discussion and Analysis

The MD&A is a narrative report prepared in an easy-to-read format by the government's financial manager. It should:

- Introduce the basic financial statements.
- Provide an analytical overview of the government's financial activities for the year based on currently known facts and the financial manager's knowledge of the transactions, events, and conditions reflected in the financial report and the fiscal policies that control the government's operations. Use of charts, tables, and graphs is encouraged.

Scope. The narrative should be based on information that management has as of the date of the auditor's report. The focus of the MD&A should be on the primary government, and the analysis should distinguish between information that pertains to the primary government and that of its component units.

RSI. The MD&A must be presented as required supplementary information (RSI) *before* the basic financial statements. (Most RSI follows the notes to the financial statements, but an exception was made for the MD&A.) This was done to ensure that the information is presented and that auditors are associated with it at a reasonable cost. Under auditing standards, auditors are required to apply certain limited procedures to RSI even though it is not part of the basic financial statements. In addition, the auditor's report should include an other-matter paragraph that refers to the RSI.

Required Components. The information in the MD&A must be confined to the following eight components:

- *A Brief Discussion of the Relationships of the Basic Financial Statements to Each Other and the Major Differences in the Information Provided in Each.* An analysis should be included that will help readers determine whether the measurements and results in fund financial statements provide additional information for analysis or corroborate conclusions drawn from government-wide statements. For example, the discussion should explain why there was a positive change in net position of governmental activities even though the general fund had a significantly different effect in its fund balance at the same time.
- *A Comparison in Condensed Form of Information Presented in the Government-wide Financial Statements for the Current and Prior Year.* The statements must include the information needed to support the following analysis of the government's overall financial position and results of operations addressing certain specified elements.
- *An Analysis of the Government's Overall Financial Position and Results of Operations to Help Users Assess Whether Financial Position Has Improved or Deteriorated Due to Current Year Activities.* The analysis should include reasons for significant changes and important economic factors, such as changes in the tax or employment bases.
- *An Analysis of Balances and Transactions of Individual Funds, Including Any Significant Changes and Any Limitations That Might Affect the Availability of Fund Resources in the Future.*
- *An Analysis of Significant Budget Variances (Original vs. Final Budget and Final Budget vs. Actual Results) for the General Fund or Its Equivalent, Including Reasons for Those Variances That May Affect Future Services or Liquidity.*
- *A Summary of Significant Capital Asset and Long-term Debt Activity with a Discussion of Commitments and Limitations That May Affect Future Financing of Planned Facilities or Services.*
- *A Discussion of Infrastructure Assets (if the Government Has Elected Not to Depreciate Such Assets).* The discussion should include information about the assessed condition of those assets and differences between estimated maintenance costs and actual amounts spent.
- *A Description of Facts, Conditions, or Decisions of Which Management Was Aware on or before the Audit Report Date That Are Expected to Have a Significant Impact on Financial Position or Results of Operations after the Reporting Date.* GASBS No. 56 indicates that it may be necessary to discuss subsequent events or going concern issues.

Relationship of MD&A to Transmittal Letter. GASBS No. 34 encourages governments that present a transmittal letter in a CAFR not to duplicate information contained in MD&A. The transmittal letter may focus more on information that is not a required component (such as subjective or prospective information) or elaborate on information in the MD&A. SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, specifies procedures to be performed on other information such as a transmittal letter. Those procedures primarily involve the reading of other information to determine if there are any inconsistencies with the financial statements.

Government-wide Financial Statements

The first group of basic financial statements required by GASBS No. 34 is the government-wide financial statements. These statements are comprised of a statement of net position and a statement of activities. The government-wide financial statements must be prepared using the economic resources measurement focus and the accrual basis of accounting. The statements should contain a columnar presentation of governmental activities, business-type activities, and component units. A total column should be presented for the primary government. A total column may be presented for the entity as a whole, but is not required.

The government-wide financial statements contain significant differences from the fund financial statements. For example—

- The statement of net position and statement of activities focus on the government "taken as a whole" rather than on fund types.
- The statement of net position reports all capital assets, including infrastructure, and the statement of activities reports depreciation expense. However, governments can avoid depreciating infrastructure by (a) using an asset management system with prescribed characteristics and (b) documenting that the assets are being preserved at an established and disclosed condition level.
- Capital outlays for governmental activities are reported as capital assets rather than expenditures. Long-term debt proceeds and principal payments are reported as long-term liabilities rather than as other financing sources and expenditures.
- Net position is classified in the following three categories—net investment in capital assets, restricted, and unrestricted. (Restricted net position should distinguish between major types of restrictions.)
- The statement of activities measures "net (expense) revenue" for each of the government's functions and reports revenues by function/program, with general revenues (such as taxes) reported separately. The level of detail of the government-wide statements is at least the same level as that used for the fund financial statements.
- Fiduciary activities are excluded from the government-wide statements because those resources are not available to finance the government's programs.
- Most interfund balances and activities are reclassified and eliminated.

The accrual basis of accounting for governmental activities changes equity in the statement of net position as compared to equity in the governmental balance sheet that is reported on the modified-accrual basis of accounting. For example, government-wide reporting of governmental activities includes capital assets and the full accrual of receivables, which increase net position, and long-term liabilities, such as debt and pension obligations, which decrease net position.

Fund Financial Statements

Fund financial statements are presented by fund category with the reporting emphasis on individual major funds. Exhibit 1-3 lists the required financial statements, measurement focus, and basis of accounting for each fund category. The following items should be considered when preparing the fund financial statements:

- Separate columns are required for the general fund and other *major* governmental and enterprise funds. Major funds are those whose revenues, expenditures/expenses, assets and deferred outflows of resources, or liabilities and deferred inflows of resources are at least 10% of corresponding totals for all governmental *or* all enterprise funds and for that same element are at least 5% of the combined totals of the governmental and enterprise funds. In addition, any other fund that government officials feel has importance to financial statement users may be reported as a major fund. Nonmajor funds are reported in the aggregate in a separate column. Major fund reporting does not apply to internal service or fiduciary funds. Proprietary fund statements should report internal service funds in the aggregate in a separate column. Fiduciary fund statements report by fund type and should also include fiduciary component units.

- A summary reconciliation to the government-wide financial statements has to be presented at the bottom of the fund financial statements or in an accompanying schedule. This is necessary since different measurement focuses are used in the statements. Common reconciling items will include capital assets and long-term liabilities.

- Governmental fund balances are classified as nonspendable, restricted, committed, assigned, or unassigned, as applicable. Proprietary fund net position is classified as net investment in capital assets, restricted, and unrestricted, as applicable.

- Proprietary funds must use the direct method for cash flows statements.

Notes to the Financial Statements

GASBS No. 34 indicates the notes to the financial statements should focus on the primary government (that is, the governmental activities, business-type activities, major funds, and nonmajor funds in the aggregate). In addition, GASBS No. 34 addresses specific disclosures that include—

- A summary of significant accounting policies based on the requirements of the Statement.

- Information about capital assets and long-term liabilities (including separate disclosure of capital assets not being depreciated).

- Information about donor-restricted endowments.

- Segment information for enterprise funds.

Several other GASB Statements establish requirements for specific note disclosures, some of which are quite complex. Those disclosures are discussed where relevant throughout this course.

Required Supplementary Information (RSI)

RSI, except the MD&A, should be presented immediately after the notes to the financial statements. In addition to MD&A, RSI includes—

- Supplementary information required under GASBS Nos. 10, 34, 67, 68, 73, 74, 75, and 78.

- Budgetary comparison schedules for the general fund and each major special revenue fund with a legally adopted budget (unless the government elects to include the required information in a budgetary comparison *statement* as part of the basic financial statements, rather than as RSI).

- Schedules and accompanying disclosures of infrastructure assets (only if a government elects to use the modified approach and not to depreciate such assets).

The budgetary comparison schedule must include the original and final budget amounts, as well as actual amounts. Though encouraged, a column with variance calculations between actual and either budget amounts is not required.

Separate Financial Statements of a Primary Government

A primary government may need to issue separate financial statements that do not include the financial data of its component units to satisfy specific legal requirements or for other reasons. Those statements generally follow all relevant presentation aspects of the basic financial statements. GASBS No. 14, however, requires that separate statements of the primary government must acknowledge that they do not include the data of the component units necessary for reporting in conformity with GAAP.

Separate Financial Statements of a Component Unit

The definition and display provisions of GASBS No. 14 should be applied to separate financial statements of a component unit as if they were the statements of the primary government. Such statements should acknowledge that the component unit is part of another government; for example, Parr County Housing Authority, a component unit of Parr County. Also, the notes to the financial statements should identify the primary government and describe the relationship of the component unit to the primary government.

Financial Statements of an Individual Fund, Agency, or Department

Many governments choose to or are required to issue separate GAAP-based financial statements for their individual funds, agencies, or departments—reporting units that are less than governments because they have no separate legal standing. Such statements should identify the primary government and disclose the limited reporting objective. GASBS No. 34 addresses the minimum requirements for GAAP financial reports issued by state and local governments. All general and special purpose governments must include a minimum of MD&A, basic financial statements, notes to the financial statements, and other RSI in their GAAP financial reports. The GASB does not address the required content of reports of individual funds, departments, or agencies. However, the AICPA has taken the position that all of the minimum required components must be present for the auditor to issue an opinion that the fund, departmental, or agency financial report is presented fairly in accordance with GAAP.

Comprehensive Annual Financial Report

GASB Cod. Sec. 2200.101 recommends that governmental units issue a comprehensive annual financial report (CAFR) as the official annual report. A CAFR includes (a) basic financial statements, (b) management's discussion and analysis and other required supplementary information, and (c) combining and individual fund statements. The CAFR also includes introductory information, schedules, and statistical data. The auditor's responsibility for information accompanying the basic financial statements and required supplementary information in a CAFR will vary according to the terms of the particular engagement.

GOVERNMENTAL FINANCIAL STATEMENTS THAT ARE PREPARED IN ACCORDANCE WITH A SPECIAL PURPOSE FRAMEWORK

As in the commercial sector, a governmental unit might want or need to issue financial statements prepared in accordance with a special purpose framework, that is, a basis of accounting other than GAAP. For instance, a statute might prescribe a basis of accounting that demonstrates compliance with the cash basis and budget laws.

AU-C 800B, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, provides requirements relevant to auditing financial statements prepared in accordance with a special purpose framework as well as limited guidance on presentation of such statements. Typically, if a governmental entity presents non-GAAP financial statements, they are either the cash or regulatory basis. However, AU-C 800B.07 identifies all of the following as being special purpose frameworks:

- *Cash Basis:* A basis of accounting that an entity uses to record cash receipts and disbursements. (The cash basis of accounting includes modifications having substantial support, such as recording depreciation on capital assets. Thus, an entity might present financial statements using a pure cash basis or a modified cash basis.)

- *Regulatory Basis:* A basis of accounting that an entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction it is subject.
- *Tax basis:* A basis of accounting that an entity uses to file its tax return for the period covered by the financial statements. (SLG, Paragraph 17.01, indicates that the tax basis would not be applicable to governmental financial statements.)
- *Contractual basis:* A basis of accounting that an entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
- *Other basis:* A basis of accounting that utilizes a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

As previously discussed, the AICPA issued SAS No. 139, which amends the AU-C 800 series (i.e., AU-C 800, AU-C 805, and AU-C 810) to conform the auditing standards in those sections to SAS No. 134. In addition to conforming amendments, SAS No. 139 provides limited additional changes to the AU-C 800 series, including clarifying the applicability of AU-C 570B, *The Auditors Consideration of an Entity's Ability to Continue as a Going Concern*, to audits of special purpose financial statements. SAS No. 139, as deferred by SAS No. 141, is effective for audits of financial statements for periods ending on or after December 15, 2021, with early implementation permitted.

The AICPA offers a practice aid, *Applying OCBOA in State and Local Governmental Financial Statements*. [Special purpose frameworks and OCBOA (other comprehensive basis of accounting) are synonymous.] This AICPA publication addresses cash basis, modified cash basis, and regulatory basis of accounting.

Presentation and Disclosure Requirements

Generally, special purpose financial statements should follow relevant GAAP presentation and disclosure requirements and be accompanied by MD&A and other applicable supplementary information, such as budgetary comparison schedules for the general fund and major special revenue funds. When such information accompanies special purpose financial statements, it is referred to as *other information* or *supplementary information*, not as *required supplementary information*.

Special purpose financial statements should be appropriately titled to indicate the basis of accounting used. The financial statements can include a reference to the notes such as "See accompanying notes to the financial statements." The financial statements should include a summary of significant accounting policies and adequately describe how the basis of the presentation differs from GAAP; however, the differences do not have to be quantified.

AU-C 800B.A19–.23 and .A34 provide the following presentation guidance:

- The discussion of the basis of presentation and how the basis differs from GAAP, which is required by AU-C 800B.15, ordinarily only describes the primary differences from GAAP. The differences from GAAP do not have to be quantified. (AU-C 800B.A18)
- When the financial statements contain items the same as, or similar to, those in financial statements prepared in accordance with GAAP, similar informative disclosures are appropriate. For example, disclosures for depreciation and long-term debt should be comparable to those in financial statements prepared in accordance with GAAP. The financial statements may either provide the relevant disclosure or provide information that communicates the substance of that disclosure. For example, the notes to the financial statements may disclose the repayment terms of long-term debt in a way that communicates information about future principal payments but does not provide the summary of payments for each of the next five years and in five-year increments thereafter that would be needed in a GAAP presentation. (AU-C 800B.A21)
- If GAAP would require disclosures of other matters, those same disclosures or disclosures that communicate the substance of those requirements should be made to the extent they are relevant to the basis of accounting. For example, going concern considerations are relevant to cash, modified cash, and regulatory basis presentations and should be disclosed if necessary, but information about the use of estimates is

not relevant in a presentation of cash receipts and disbursements that has no estimates. (AU-C 800B.17, .A21, and .A34)

- Special purpose financial statements also should include other applicable disclosures that are necessary to achieve fair presentation, such as those for subsequent events, related party transactions, and significant uncertainties. (AU-C 800B.A22)
- GAAP disclosure requirements that are not relevant need not be considered. (AU-C 800B.A34)
- If GAAP provides requirements for the *presentation* of financial statements, special purpose financial statements should either comply with those requirements or provide information that communicates the substance of those requirements. (AU-C 800B.A34)
- A statement of cash flows might not be included in special purpose financial statements. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the government chooses to present such a statement, it should either conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements. (AU-C 800B.A34)

According to SLG, Paragraph 17.02, special purpose financial statements may not omit a basic financial statement that is required by GAAP or substitute similar information for a required statement. Instead, substantially similar information may be presented within a required financial statement. For example, GAAP generally requires presentation of government-wide financial statements, inclusion of columns for major funds in the fund financial statements, and separate identification of special and extraordinary items. Special purpose financial statements should include similar government-wide financial statements and a columnar presentation of major funds. However, special and extraordinary items could be disclosed in a note instead of being presented on the face of the financial statements.

AU-C 800B.08 states that the requirements of the applicable financial reporting framework determine the form and content of the financial statements and what represents a complete set of financial statements. According to SLG, Paragraph 17.04, the requirements regarding presentation of a complete set of financial statements do not apply to special purpose financial statements where contractual agreements or regulatory requirements direct presentation of less than a complete set of financial statements. Such financial statements are not required to include all of the basic financial statements required by GAAP. For example, a regulatory provision may require presenting a schedule of cash receipts and disbursements by fund only. That regulatory basis presentation is not intended to present financial position. The lack of a schedule of cash is not a deficiency, nor is the presentation deficient because it lacks other GAAP-required basic financial statements.

Audit Considerations

AU-C 210B establishes certain preconditions for an audit, including determining the acceptability of the financial reporting framework. In addition to these requirements, AU-C 800B states that the auditor should obtain an understanding of (a) the purpose for which special purpose financial statements are prepared, (b) the intended users of the financial statements, and (c) the steps taken by management to determine that the applicable special purpose financial reporting framework is acceptable in the circumstances.

According to SLG, Paragraph 17.11, when special purpose financial statements are prepared in accordance with a contractual basis of accounting, the auditor should obtain an understanding of any significant interpretations of the contract that resulted in financial information being materially different from information that would have been presented if management had used another reasonable interpretation.

AU-C 800B also requires the auditor to evaluate whether special purpose financial statements are suitably titled, include a summary of significant accounting policies, and adequately describe differences between the special purpose framework and GAAP. Specifically, AU-C 800B.17 states that when special purpose financial statements include items that are the same as or similar to those in GAAP financial statements, the auditor should evaluate whether the financial statements include informative disclosures similar to those required by GAAP. The auditor also should evaluate whether additional disclosures, beyond those specifically required by the framework, that are related to matters not specifically identified on the face of the financial statements, or other disclosures, are necessary for the financial statements to achieve fair presentation.

AU-C 800B.18–.23 provides requirements for the auditor's report on special purpose financial statements, including requirements specific to regulatory basis financial statements.

The Auditor's Consideration of Opinion Units for Special Purpose Financial Statements. For special purpose financial statements, the auditor generally considers opinion units as they would be considered in an audit of GAAP-basis financial statements. Generally, the opinion unit concept requires the auditor to plan, perform, evaluate the results, and report based on governmental activities, business-type activities, aggregate discretely presented component units, each major governmental and enterprise fund, and aggregate remaining fund information (i.e., opinion units).

SLG, Paragraph 17.13, addresses reporting on special purpose financial statements where contractual provisions or regulatory agreements direct the presentation. In such presentations the opinion unit concept may not apply. For example, the contractual party or regulator may require that the auditor determine materiality and express an opinion on the financial statements as a whole. In such cases, the auditor should look to guidance from the regulatory agency or contract for determining materiality and the opinion units on which to report. If no guidance is provided, the auditor may use professional judgment in applying the opinion unit concept. In that situation, the auditor should consider disaggregations (such as columnar disaggregations) of the presentation (and perhaps certain aggregations of those presentations that represent remaining fund information) to be separate opinion units.

REQUIREMENTS FOR AUDITING A GOVERNMENTAL ENTITY

As previously discussed, the auditor may need to follow three types of interrelated auditing requirements when auditing a governmental entity:

- AICPA generally accepted auditing standards (GAAS).
- *Government Auditing Standards* issued by the Comptroller General of the United States (the Yellow Book).
- The Single Audit Act and Office of Management and Budget's (OMB) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) (also referred to as Single Audits).

Note: On August 13, 2020, the Office of Management and Budget (OMB) published the final revisions to sections of Title 2 of the Code of Federal Regulations (CFR) Subtitle A—*OMB Guidance for Grants and Agreements*. OMB states that the purpose of the revisions is to reduce the burden on grant recipients; provide guidance on implementing new statutory requirements; and improve federal financial assistance management, transparency, and oversight. The changes are effective November, 2020, except for the amendments in section 200.216 (Prohibition on certain telecommunications and video surveillance services or equipment) and 200.340 (Termination), which are effective August 13, 2020. While the revisions to Subpart F, *Audit Requirements*, of the Uniform Guidance, are not substantive, a number of the revisions to other subparts do affect certain grant and compliance requirements that auditees need to follow, including procurement and indirect costs. Auditors should be familiar with these revisions and consider the effective dates of the respective provisions on various aspects of compliance and the audit.

Governmental units have audits of their financial statements for a variety of reasons. Local or state laws may require an audit of the governmental unit's financial statements, a granting agency providing funds to the governmental unit may require an audit of the expenditure of those funds, and lenders or financial intermediaries in a bond issue may recommend or require an audit of the governmental issuer's financial statements. The Single Audit Act requires governmental units that expend stipulated amounts of federal awards to undergo an audit of their financial statements. (The law also requires a study and evaluation of internal control and compliance with laws and regulations relevant to major federal award programs.)

Types of Audits

GAAS Audit. Auditors of governmental entities should conduct their engagements in accordance with the AICPA's generally accepted auditing standards, which were discussed earlier in this lesson.

Financial Audit—*Government Auditing Standards*. Financial audits provide an independent assessment of whether an entity's reported financial information (e.g., financial condition, results, and use of resources) are presented fairly in accordance with an applicable financial reporting framework. Financial audits performed in accordance with *Government Auditing Standards* include financial statement audits and other related financial audits.

The primary purpose of a financial statement audit is to provide an opinion (or disclaimer of an opinion) about whether the financial statements are presented fairly in all material respects in accordance with GAAP or with a special purpose framework. Other types of financial audits under *Government Auditing Standards* provide for different levels of assurance and encompass various scopes of work, including: (a) providing an opinion on single financial statements, specified elements, accounts, or items of a financial statement; (b) issuing letters for underwriters and certain other parties; and (c) auditing compliance with applicable compliance requirements relating to one or more government programs.

The Yellow Book incorporates GAAS. Thus, performing a financial audit requires auditing the financial statements in accordance with GAAS, as well as following the additional general, performance, and reporting standards in *Government Auditing Standards*. This includes reporting on internal control over financial reporting and compliance and other matters. An audit of financial statements in accordance with the Yellow Book also includes other reporting and documentation responsibilities, as discussed in more detail throughout this course, as needed.

In July 2018, the GAO issued *Government Auditing Standards, 2018 Revision* (the 2018 Yellow Book). The 2018 Yellow Book is effective for financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020, and for performance audits beginning on or after July 1, 2019. This course reflects the 2018 Yellow Book.

Compliance Audits. AU-C 935B, *Compliance Audits*, addresses the application of GAAS to a compliance audit, such as a Single Audit. AU-C 935B applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards;
- *Government Auditing Standards* requirements for financial audits; and
- A governmental audit requirement that requires an opinion on compliance.

AU-C 935B provides guidance on applying GAAS in a compliance audit. Although a compliance audit is usually performed in conjunction with a financial statement audit, AU-C 935B does not apply to the audit of the financial statements.

As previously discussed, the AICPA issued SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, and 940*, to update that section for the issuance of SAS No. 134. AU-C 935, *Compliance Audits*, was revised to be consistent with changes in the OMB Compliance Supplement and issuance of the most recent Yellow Book and Uniform Guidance. These changes include amending the definition of material noncompliance to conform with SAS No. 138, *Amendments to the Description of the Concept of Materiality*, and reversing the reporting options order by making a combined report on compliance and internal control over compliance the first and default option, followed by a second option of issuing separate reports on (a) compliance and (b) internal control over compliance. SAS No. 140, as deferred by SAS No. 141, is effective for audits of financial statements for periods ending on or after December 15, 2021, with early implementation permitted.

Program Compliance Audit. Federal program grant agreements may require grant recipients to obtain program compliance audits. In program compliance audits, auditors express opinions on (a) the recipient's compliance with the provisions of particular federal grant program agreements and (b) the governmental unit's eligibility for federal funds under those programs. Standards for specific program or grant audits would be found in federal audit guides related to the specific programs.

Single Audit. The Single Audit Act requires state and local governmental units expending certain amounts of federal awards to obtain an independent "Single Audit" of all federal funds expended under major federal programs. Such an audit replaces separate audits of individual grants to which the entities would otherwise have been subject under federal requirements. A Single Audit consists of (a) a financial audit performed in accordance with *Government Auditing Standards*, (b) a study and evaluation of the governmental unit's internal control over federal awards programs, and (c) tests of the governmental unit's compliance with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major program. The Single Audit Act's internal control and federal program compliance requirements exceed minimum requirements under GAAS and the Yellow Book.

Generally Accepted Auditing Standards

This course is primarily devoted to the application of GAAS in the audit of a governmental unit's financial statements. To apply GAAS, the auditor follows the guidance and requirements in the SASs, related auditing interpretations, and audit and accounting guides (SLG, GAS/SA Audit Guide, and other applicable AICPA guides).

AICPA Fieldwork Standards. AU-C Preface, *Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with GAAS. These principles are not requirements and are not authoritative. Rather, they provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The preface explains that to obtain the reasonable assurance needed to express an opinion on the financial statements, the auditor does the following:

- Plans the work and properly supervises assistants.
- Determines and applies appropriate materiality levels throughout the audit.
- Identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including its internal control.
- Obtains sufficient appropriate audit evidence about whether material misstatements exist by designing and implementing appropriate responses to assessed risks.

The application of these activities is discussed in more detail where relevant throughout this course.

GAAS Requirements Related to Compliance with Laws and Regulations. In the audit of a governmental entity, substantial attention is paid to compliance with laws and regulations. Although management is responsible for ensuring that the entity complies with laws and regulations applicable to its activities, the auditor is responsible, in a GAAS audit, for considering not only laws and regulations, but also provisions of contracts and grant agreements and how they affect the audit. Thus, the auditor is responsible for obtaining reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws, regulations, contracts, and grant agreements that have a material effect on the financial statements.

Government Auditing Standards

Financial audits under the GAO's *Government Auditing Standards* incorporate GAAS and add requirements that extend beyond GAAS. *Government Auditing Standards* includes standards for financial audits as well as attestation engagements and performance audits. The Yellow Book incorporates GAAS. Thus performing a financial audit requires auditing the financial statements in accordance with GAAS, as well as following the additional general, field work, and reporting standards in *Government Auditing Standards*. The Yellow Book describes ethical principles that are the foundation of governmental audits and establish requirements for the scope of audit work, auditor qualifications and independence, competence of the audit staff, exercise of professional judgment, and quality control and external peer reviews, as well as standards for planning, supervision, and reporting. For example, some of the additional requirements extend beyond GAAS in the following ways:

- More extensive documentation requirements related to independence than the AICPA independence standards. In addition, the Yellow Book conceptual framework for independence is used more frequently than the AICPA's conceptual framework.
- More restrictive continuing education requirements than the AICPA requirements.
- More requirements relating to communication during the planning stage of the audit.)
- An unconditional requirement that auditors must use professional judgment in planning, performing, and reporting on audits and attestation engagements.
- More requirements for considering the results of previous audits and attestation engagements.
- More extensive reporting requirements, which include planning and performing procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives.
- More extensive quality control and assurance requirements.
- Additional considerations relating to audit documentation.

The federal government's response to the ongoing COVID-19 pandemic has been unprecedented, resulting in significant federal financial assistance being provided to individuals, small businesses, nonprofit organizations, schools, healthcare entities, and state and local governments, among others.

In July 2018, the GAO issued the 2018 Yellow Book to update for developments in auditing and accountability, and financial management since the 2011 edition. The 2018 Yellow Book is effective for financial audits, attestation engagements, and reviews of financial statements for periods ending on or after June 30, 2020, and for performance audits beginning on or after July 1, 2019. This course is designed for audits conducted under the 2018 Yellow Book.

Note that many of these additional standards relate more to reporting than to audit procedures for the audit of the financial statements. That is, many of the standards for performing an audit are essentially the same under GAAS and the Yellow Book. A link to the 2018 Yellow Book is included in *PPC's Government Documents Library* at Gov. Doc. No. 2. The 2018 Yellow Book is also available on the GAO's website at **www.gao.gov/yellowbook/overview**.

When Do *Government Auditing Standards* Apply? A Yellow Book audit can be required by law, regulation, agreement, contract, or policy. The most common Yellow Book audits are those required for federal awards subject to the Single Audit Act Amendments of 1996. In many instances, state laws or state funding agencies may require an audit in accordance with the Yellow Book, regardless of the amount of federal awards expended, if any.

The Yellow Book's Ethical Principles. The Yellow Book, in Chapters 3 and 5, discuss the fundamental ethical principles that are the foundation for all work performed under *Government Auditing Standards*. Additionally, those chapters are built on the principles and establish requirements related to independence, professional judgment, competence, quality control and assurance, and peer reviews.

The Yellow Book, at Paragraph 3.03, emphasizes that the public expects auditors to follow ethical principles when performing work under *Government Auditing Standards*. According to Paragraph 3.04 of the Yellow Book:

> Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the auditors' report.

Although the Yellow Book's ethical principles are fundamental to all work performed under *Government Auditing Standards*, they are not written as specific requirements. Instead, they provide a framework that enables auditors to consider the facts and circumstances of each situation.

The Public Interest. The Yellow Book, at Paragraph 3.07, defines public interest as "the collective well-being of the community of people and entities the auditors serve." The auditor's acceptance of responsibility to serve the public interest is considered to be critical to auditing in the government environment.

Integrity. The Yellow Book, at Paragraph 3.09, indicates that integrity includes conducting work "with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors' reports." Integrity also includes being "honest, candid, and constructive."

Objectivity. The Yellow Book, at Paragraph 3.11, indicates that objectivity includes being independent in "mind and appearance . . . maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest." Maintaining objectivity includes continually assessing relationships with audited entities and other stakeholders.

Proper Use of Government Information, Resources, and Positions. The Yellow Book, at Paragraph 3.12, emphasizes that government information, resources, and positions are to be used for official purposes. They are not to be used for personal gain or contrary to the interests of the audited entity or the audit organization. The concept of proper use includes proper handling of sensitive or classified information or resources.

Professional Behavior. The Yellow Book, at Paragraph 3.16, emphasizes that expectations for professional behavior include compliance with legal, regulatory, and professional obligations; avoidance of conduct that might discredit the auditor's work; and making an honest effort in performing their duties in accordance with the relevant technical and professional standards.

Yellow Book Independence Requirements. *Government Auditing Standards* states that in all matters relating to the audit work, the audit organization and individual auditor, whether government or public, must be independent. If independence is impaired, the auditor should decline to perform a prospective audit or should terminate one that is in progress. The Yellow Book establishes a conceptual framework that should be used to identify, evaluate, and apply safeguards to address threats to independence. The Yellow Book also identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the conceptual framework. The 2018 Yellow Book revises the requirements and application guidance on independence, especially related to nonaudit services. (The most significant change relates to preparation of a client's financial statements in their entirety and other services related to preparing accounting records and financial statements.)

Yellow Book Competence and Continuing Education Requirements. The general standard related to competence in the Yellow Book, beginning at Paragraph 4.02, states that the staff assigned to perform the audit engagement must collectively possess adequate professional competence for the tasks required. The standard is generally consistent with the unconditional professional requirements in GAAS. The Yellow Book, at Paragraph 4.04, states that an audit organization should have a process for recruitment, hiring, continuous development, assignment, and evaluation of personnel so that the workforce has the essential knowledge, skills, and abilities necessary to conduct the engagement.

The Yellow Book states that each auditor performing work under the Yellow Book, including planning, directing, performing fieldwork, or reporting on Yellow Book engagements, should complete every two years at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. In addition, auditors who do any amount of planning, directing, or reporting on Yellow Book engagements and auditors who are not involved in those activities but charge at least 20% of their time annually to Yellow Book engagements, should also obtain at least another 56 hours (for a total of 80 hours in every two-year period) of CPE that enhances their professional proficiency to perform audits. At least 20 of the 80 hours should be completed in each year of the two-year period. The Yellow Book, at Paragraph 4.26, allows nonsupervisory auditors who charge less than 40 hours of their time annually to Yellow Book engagements to be exempted from the 24-hour and 56-hour requirements. Auditors hired or initially assigned to Yellow Book audits after the beginning of an audit organization's two-year CPE period should complete a prorated number of CPE hours. (It is important to note that the Yellow Book's CPE requirements apply whether the auditor is a CPA or is not certified.)

Note: Due to the COVID-19 pandemic, the GAO issued the *COVID-19: GAGAS CPE Alert*, which provided the following exceptions for CPE requirements for auditors who perform engagements under GAGAS:

a. *A Six-month Grace Period for Completing CPE.* For two-year CPE periods that end February 29, 2020, through December 31, 2020, auditors who have not completed the 80-hour or the 24-hour CPE requirements for the two-year period may have up to six months immediately following the two-year period to make up the deficiency. Any CPE hours completed toward a deficiency in one period may be documented in the CPE records and may not be counted toward the next period's CPE reporting requirements.

b. *Waiver of 20-hour Annual CPE Requirement.* For the one-year CPE period ending February 29, 2020, through December 31, 2020, auditors are not required to meet the annual minimum of 20 hours of CPE.

c. *Carryover of CPE.* From the audit organization's two-year period in effect on February 29, 2020, auditors may carry over up to 40 hours of CPE, in excess of the 80-hour requirement, to the next CPE measurement period. Additionally, for two-year CPE measurement periods ending after December 31, 2020, only CPE hours earned through December 31, 2020, may be carried over. Any CPE hours carried over to the next measurement period will *not* count toward the next 24-hour requirement for CPE on subject matter directly related to the government environment; government auditing; or the specific, unique environment in which the audited entity operates. Carried over CPE hours also cannot be used to meet the 20-hour annual CPE requirement.

The GAO also clarified that auditors are not to use the existing CPE exemptions in Paragraph 4.29 of the Yellow Book (an extended absence due to ill health, maternity/paternity leave, extended family leave, sabbaticals, leave without pay absences, foreign residency, military services, or disasters) if the auditor is actually working, which includes "teleworking" (working remotely).

The Yellow Book, at Paragraph 4.21, states that determining what CPE subjects are appropriate to satisfy CPE requirements is a matter of professional judgment to be exercised by auditors in consultation with appropriate officials in their audit organization. In deciding appropriate CPE courses, auditors consider their knowledge, skills, and abilities, and the level of proficiency necessary, in order to be competent for their assigned roles. Auditors may consider probable future engagements to which they may be assigned when selecting specific CPE subjects to satisfy the 24-hour and the 56-hour CPE requirements.

The Yellow Book, at Paragraph 4.16, indicates that individual auditors should develop and maintain their competence by meeting the CPE requirements, and Paragraph 4.18 of the Yellow Book states the audit organization should maintain each auditor's CPE documentation.

CPE Topics and Implementation Guidance. In April 2005, the GAO issued comprehensive guidance on CPE for auditors who perform Yellow Book engagements. *Guidance on GAGAS Requirements for Continuing Professional Education* (2005 Guidance) clarifies numerous CPE issues including measurement periods, 24-hour and 80-hour requirements, and CPE topics that meet the Yellow Book requirements. The concepts, but not the detailed guidance, of the 2005 Guidance have been incorporated into the Yellow Book. However, the 2005 Guidance is still applicable under the 2011 Yellow Book. Auditors may want to refer to it for identification of acceptable CPE topics. It is available on the GAO's website at **www.gao.gov**. When effective, the 2018 Yellow Book will supersede the 2005 Guidance. Much of the relevant information included in the 2005 Guidance has been incorporated in to the 2018 Yellow Book. Chapter 4 of the 2018 Yellow Book includes application guidance related to CPE including:

- topics that qualify for the 24-hour and 56-hour requirements,
- programs and activities that qualify for CPE,
- measuring CPE, and
- monitoring CPE.

Yellow Book Communication Requirements. The Yellow Book states that auditors should make additional communications when performing Yellow Book audits. It also broadens the parties with whom auditors have to communicate and requires auditors to communicate specific information during the planning stage of a financial audit to reduce the risk that the needs or expectations of the parties involved may be misinterpreted.

Yellow Book Professional Judgment Requirements. *Government Auditing Standards* establish an unconditional requirement that auditors must use professional judgment in planning, performing, and reporting on audits. Paragraph 3.110 of the Yellow Book indicates that the concept of reasonable care requires auditors to act diligently in accordance with applicable professional standards and ethical principles. Exercising professional skepticism entails a critical assessment of audit evidence while assuming that management is neither dishonest nor of unquestioned honesty. Additionally, Paragraph 3.110 of the Yellow Book states that auditors may accept records and documents as genuine unless they have reason to believe the contrary. Auditors may consider documenting procedures undertaken to support their application of professional skepticism in highly judgmental or subjective areas under audit.

The Yellow Book also clearly states that professional judgment is both an organizational and individual responsibility. Paragraph 3.112 of the Yellow Book states—

> Professional judgment represents the application of the collective knowledge, skills, and abilities of all the personnel involved with an engagement, as well as the professional judgment of individual auditors. In addition, professional judgment may involve consultation with other stakeholders, specialists, and management in the audit organization.

Paragraph 3.113 of the Yellow Book indicates that applying professional judgment includes—

- Following the independence standards and related conceptual framework;
- Maintaining objectivity and credibility;
- Assigning competent staff/personnel to the engagement;
- Defining the scope of work;
- Evaluating, documenting, and reporting the results of the work; and
- Maintaining appropriate quality control over the engagement process.

The GAS/SA Audit Guide, Paragraph 2.41, provides the following additional considerations relative to exercising professional judgment. Though the GAS/SA Audit Guide has not been updated for the Yellow Book, the authors believe these considerations are still relevant:

- The use of professional knowledge, skills, and abilities to diligently gather information, in good faith and with integrity, and to objectively evaluate the sufficiency and appropriateness of evidence is a critical component of an audit. Professional judgment and competence are interrelated because judgments made are dependent upon the auditor's competence.
- Professional judgment represents the application of the collective knowledge, skills, and abilities of all the personnel involved with an audit, as well as the professional judgment of individual auditors. Professional judgment may also involve consultation with other stakeholders, specialists, and management in the audit organization.
- The use of professional judgment is important in performing all aspects of auditors' professional responsibilities, including following the independence standards and related conceptual framework; maintaining objectivity and credibility; assigning competent staff to the audit; defining the scope of work; evaluating, documenting, and reporting the results of the work; and maintaining appropriate quality control over the audit process.
- The use of professional judgment is important when applying the conceptual framework to determine independence for a specific situation. This includes identifying and evaluating any threats to the auditor's independence, including threats to the appearance of independence, and related safeguards that may mitigate the identified threats.

- The use of professional judgment is important in determining the required level of understanding of the audit subject matter and related circumstances. This includes consideration of whether the audit team's collective experience, training, knowledge, skills, abilities, and overall understanding are sufficient to assess the risks that the subject matter of the audit may contain a significant inaccuracy or could be misinterpreted.
- The consideration of the audit risk level, including the risk of arriving at improper conclusions, is also important. Exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

Government Auditing Standards places responsibility on each auditor and the audit organization to exercise professional judgment in planning and performing an audit. However, it does not imply unlimited responsibility or infallibility on the part of an auditor or the audit organization.

Yellow Book Reporting Requirements. The Yellow Book contains several reporting requirements that exceed GAAS requirements. Additional reporting requirements include—

- Reporting on the auditor's compliance with *Government Auditing Standards*.
- Reporting on internal control; compliance with provisions of laws, regulations, contracts, and grant agreements; and instances of fraud.
- Presenting findings in the audit report and directly to parties outside the audited entity.
- Obtaining and reporting views of responsible officials.
- Reporting confidential or sensitive information.
- Distributing reports.

Yellow Book Quality Control and Assurance Requirements. Paragraph 5.02 of the Yellow Book indicates that audit organizations conducting Yellow Book audits must establish and maintain a quality control system that is designed to provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements. The Yellow Book, Paragraph 5.84, requires an audit organization not already subject to a peer review requirement to obtain an external peer review at least once every three years. The audit organization should obtain its first peer review covering a review period ending no later than three years from the date an audit organization begins its first Yellow Book engagement (i.e., the start of field work).

The requirement in Paragraph 5.02 of the Yellow Book states "an audit organization conducting engagements in accordance with GAGAS must establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements." The requirement in Paragraph 5.04 of the Yellow Book states "an audit organization should document its quality control policies and procedures and communicate those policies and procedures to its personnel. The audit organization should document compliance with its quality control policies and procedures and maintain such documentation for a period of time sufficient to enable those performing monitoring procedures and peer reviews to evaluate the extent to which the audit organization complies with its quality control policies and procedures."

According to Paragraph 5.79 of the Yellow Book, auditors seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* should, if requested, provide the party contracting for the audit with the auditor's most recent peer review report and any subsequent peer review reports received during the period of the contract.

The Yellow Book, at Paragraph 5.77, states that external audit firms should make their most recent peer review report publicly available. This can be done, for example, by posting the peer review report on a publicly available internet site or to a publicly available site designed for transparency of peer review results. If these options are not available, the audit firm should use the same mechanism it uses to make other information public, and provide the peer review report to others upon request.

Single Audit Standards

The Single Audit involves application of GAAS, *Government Auditing Standards*, and additional requirements found in the Single Audit Act and related OMB pronouncements. Those additional requirements extend beyond GAAS and *Government Auditing Standards* for financial audits in the following ways:

- Reporting on supplementary information on federal awards programs that accompanies the basic financial statements.
- Additional assessment of internal control over federal award programs beyond the minimum consideration required by GAAS and the Yellow Book, including tests of the operating effectiveness of internal control over compliance, and additional reporting on controls.
- Testing of additional transactions for compliance with federal statutes, regulations, and the terms and conditions of federal awards relevant to major federal awards programs and additional reporting providing an opinion on compliance.

Summary of Additional Compliance Testing and Internal Control Responsibilities Audit Standards. Exhibit 1-5 presents the additional compliance testing and internal control requirements in a Single Audit conducted in accordance with the Uniform Guidance adapted from the table presented in the GAS/SA Audit Guide, Paragraph 5.08.

Exhibit 1-5

Additional Compliance Testing and Internal Control Responsibilities in a Single Audit Conducted in Accordance with the Uniform Guidance

	Obtaining Sufficient Appropriate Audit Evidence	**Reporting Responsibilities**
Compliance Testing Responsibilities	The auditor must determine whether the auditee has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each of its major programs.	The auditor must report on compliance for each major program and express or disclaim an opinion about whether the auditee complied with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major program and, where applicable, refer to the separate schedule of findings and questioned costs.
Internal Control Responsibilities	With regard to internal control over compliance, the auditor must do the following: (1) perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk of noncompliance for each major program, (2) plan the testing of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program, and (3) perform tests of internal control over compliance as planned (unless the internal control is likely to be ineffective in preventing or detecting noncompliance). The auditor may use evidence gained from the tests of controls over compliance to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements that have a direct and material effect on each of its major programs.	The auditor must provide a written report on internal control over compliance for major programs describing the scope of internal control testing and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs. No opinion on internal controls is required.

ACCOUNTING AND AUDITING CONCERNS RELATED TO COVID-19

COVID-19 has presented many challenges to everyone in society, including financial statement preparers and auditors. Tasks related to financial statement preparation and auditing that were once predictable and routine have become just the opposite. For example, auditors need to consider risks associated with the COVID-19 outbreak as they plan and perform their audit, including obtaining or updating their understanding of the entity and its environment and identifying risks. The COVID-19 outbreak's impact will likely affect the entity's environment, regulatory, and other external factors. The entity's operations could also be significantly affected by its ability to deliver on its services and commitments. The volatile financial markets could impact the valuation of the entity's investments and financing sources. Further, the impact of COVID-19 has probably affected the comparability of information regarding the entity's operations, industry conditions, financial results, nonfinancial measures, etc. The COVID-19 pandemic's impact may have dramatically changed procedures and controls to accommodate remote workforces or changes in operations. Also, an auditee may have had a different set of controls before, during, and after the pandemic. For example, controls used to mitigate pre-COVID-19 risks may no longer be operable.

In addition, the federal government's response to the ongoing COVID-19 pandemic has been unprecedented, resulting in significant federal financial assistance being provided to individuals, small businesses, nonprofit organizations, schools, healthcare entities, and state and local governments. As a result, many recipients may be subject to needing single audits for the first time, while others may be receiving much larger awards creating new major programs. In response, the OMB and federal agencies have made many rule changes affecting these federal awards.

COVID-19 resources are discussed in the following paragraphs.

AICPA

The AICPA has not released new standards to respond to issues arising from COVID-19. However, in May 2020, SAS No. 141 was issued to delay the effective dates by one year for the recently issued SAS Nos. 134–140, to provide relief to firms struggling with the ramifications of the COVID-19 pandemic. The AICPA has provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the engagement issues created as well as the impact of federal awards. These resources can be found at **https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center** and at their Government Audit Quality website at **www.aicpa.org/interestareas/governmentalauditquality.html**.

GASB Technical Bulletin 2020-1

The COVID-19 pandemic prompted the GASB to issue a Technical Bulletin 2020-1, *Accounting and Financial Reporting Issues Related to the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and Coronavirus Diseases*, to provide guidance for unique accounting issues related to the federal assistance and the reporting for state and local governments. The Technical Bulletin was issued in question and answer format and addresses Coronavirus Relief Fund (CRF) eligibility requirements or purpose restrictions, lost revenue, subsequent events, the Paycheck Protection Program (PPP), operating or nonoperating revenue presentation, and special or extraordinary item presentation. The following is a summary of the issues discussed in the Technical Bulletin:

- *Coronavirus Relief Funds.* Question 1 addresses whether the resources from the Coronavirus Relief Fund are subject to eligibility requirements or to purpose restrictions and when revenue from those resources should be recognized. GASB concluded that the CARES Act funding is considered to be a voluntary nonexchange transaction under GASB Statement No. 33. Therefore, a recipient government should recognize resources received as liabilities until the applicable eligibility requirements are met, which typically consist of the incurrence of eligible expenditures. Once the eligibility requirements have been satisfied, the government should then recognize revenue.

- *Loss of Revenue.* Question 2 addresses the CARES Act resources that are available to replace lost governmental revenue because of the pandemic. A governmental entity's response to address the pandemic often required suspension of services, which caused revenue losses. GASB considers these actions as an eligibility requirement that allows the entity to access these particular federal funds. GASB concluded that resources received from CARES Act programs that specifically include an eligibility requirement for loss of revenue should be recognized as revenue when the government meets the action-based eligibility requirement.

- *Subsequent Events.* Question 3 discusses the potential impact of amendments to the CARES Act. If the CARES Act is amended after the government's year-end reporting date, but prior to the issuance of financial statements, the government should not change its recognition in that fiscal year. However, these changes should be classified as "subsequent events" that would merit a note disclosure.

- *Paycheck Protection Program.* Question 4 in the Technical Bulletin addresses the issue of reporting forgivable loans by nonprofit entities reporting under GASB standards. These loans are guaranteed through a nonexchange financial guarantee provided by the U.S. Small Business Administration, but forgiveness is based on compliance with program requirements. The GASB suggests that the loan should continue to be reported as a liability until the entity is legally released from the debt. In the period that the entity receives that release, the entity will also recognize an inflow of resources for the amount of the original loan.

- *Operating or Nonoperating Revenue Presentation.* Certain resources in the CARES Act may be awarded to governmental business-type activities. This would include resources from the Department of Health and Human Services (HHS) Provider Relief Fund, Education Higher Education Emergency Relief Fund, Federal Aviation Administration (FAA) aviation grants, and Transit Rural Areas and Urbanized Area Formula Grants. Question 5 suggests that these resources are subsidies and should be reported as nonoperating revenues. The Technical Bulletin also references GASBS No. 34, paragraph 102; GASBS No. 9, paragraph 21; and Question 2.27.4 in the GASB Comprehensive Implementation Guide for further discussion of how to determine whether these inflows are operating or nonoperating. One exception to this nonoperating classification would be any payments to governmental healthcare providers from the Provider Relief Fund Uninsured Program for COVID-19-related care or treatment of uninsured patients. These payments are based on services provided and would therefore be treated as operating revenues.

- *Special or Extraordinary Item Presentation.* Question 6 in the Technical Bulletin discusses whether outflows of resources related to COVID-19 efforts should be reported as extraordinary or special items (GASBS No. 34, paragraph 55) in governmental financial operating statements. The Technical Bulletin explains that since pandemics, the underlying event, are likely to occur in the future and certainly have occurred in the past, the pandemic itself does not meet the definitions of unusual or infrequent. In addition, the underlying event, the pandemic, is not within management's control. Therefore, management's response and the related outflows of resources do not meet the criteria for either extraordinary or special item reporting.

The Technical Bulletin is available at **www.gasb.org/jsp/GASB/Document_C/DocumentPage?cid=1176174832053&acceptedDisclaimer=true**.

GASB Emergency Toolbox

GASB has added a new feature to their website to assist preparers and auditors as they evaluate some of the unusual circumstances for governmental accounting and reporting during this pandemic crisis. In July 2020, after the Board had issued Technical Bulletin 2020-1, GASB added an Emergency Toolbox at **www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174469582**, to highlight existing standards and resources that may be useful for governmental entities. The site includes direct links to relevant standards and resources. GASB focuses on stakeholders, a broader audience that just preparers and auditors, meaning that users of governmental financial statements may also find the Emergency Toolbox to be beneficial. The key issues addressed in the Emergency Toolbox include:

- Disclosures related to outflows of resources incurred in response to COVID-19.
- Donated inventory.
- Nonexchange financial guarantee disclosures.
- Subsequent contravention of eligibility requirements.
- Classification of transactions not addressed by Category A or Category B guidance as either operating or nonoperating revenues and expenses.
- Extension of property tax due dates.
- Subsequent events disclosures for legislation enacted after the end of the reporting period.

Government Finance Officers Association

GFOA's Fiscal First Aid (**www.gfoa.org/ffa**) was developed to provide resources for a wide range of unexpected financial crises, but also applies to this COVID-19 pandemic. GFOA has developed a 12-step Fiscal First Aid Recovery Process, which is outlined on this site. The process helps governments identify both short-term and long-term options for addressing a financial crisis.

Summary

The authors suggest that governments evaluate the specific impact of the COVID-19 pandemic on their government to determine what accounting or reporting issues should be addressed. The impact will vary significantly among governments, depending on the severity of the outbreak in the community, how public safety agencies are funded and respond to the crisis, and the government's long-range fiscal sustainability planning for the unexpected. Updated information and financial statement considerations related to the COVID-19 pandemic are available at **checkpoint.riag.com** and **www.thomsonreuters.com**.

USING THE PPC AUDIT PROCESS

Generally accepted auditing standards require auditors to use information gathered about the entity and its environment (including internal control) to identify and assess the risks of material misstatement at both the overall financial statement and relevant assertion levels, and to determine the nature, timing, and extent of further audit procedures needed to respond to those risks. Further audit procedures are required to be performed to obtain audit evidence to support the auditor's opinion.

The authors have developed a practical approach to that audit process to address the requirements of authoritative literature and have designed practice aids to assist auditors in meeting those requirements. (Those practice aids are available in *PPC's Guide to Audits of Local Governments*, as discussed below.) PPC's audit approach is designed to be flexible and adaptable, allowing auditors to better leverage their knowledge of the client to tailor their audit procedures. PPC has tailored this approach for use in all of our industry audit guides so that auditors can use a common audit approach in all of their audits. The audit approach has been divided into the following broad steps:

Step 1 Perform procedures regarding acceptance/continuance of the client relationship, evaluate compliance with ethical requirements (including independence), and establish an understanding with the client in an engagement letter.

Step 2 Develop a preliminary audit strategy, establish planning materiality, and perform risk assessment procedures to gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements and, if applicable, material noncompliance.

Step 3 Gather the information to understand and evaluate the design and implementation of the entity's internal control system.

Step 4 Synthesize the information gathered, identify risks (both overall and specific) that could result in a material misstatement of the opinion unit financial statements and, if applicable, material noncompliance, and finalize the overall audit strategy.

Step 5 Assess the risks of material misstatement of the entity's financial statements and, if applicable, material noncompliance.

Step 6 Develop and perform appropriate responses (further audit procedures) to the assessed risks of material misstatement of the financial statements and, if applicable, material noncompliance considering the overall audit strategy and planning materiality.

Step 7 Evaluate audit findings and evidence.

Step 8 Prepare required reports and communications.

Although the requirements and guidance 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 client's financial statements. Therefore, the audit process is an iterative, nonlinear process, whereby the required procedures may be performed concurrently with other procedures. In addition, risks should be evaluated continuously throughout the audit.

Practice Aids

PPC's Guide to Audits of Local Governments contains practice aids that guide the auditor through the entire audit process. By using the PPC practice aids, auditors can efficiently conduct an audit of a local government in accordance with authoritative literature.

PPC Workflow Tools. Thomson Reuters offers the following tools that may provide even more efficiency when conducting an audit of a governmental entity:

- *PPC's Practice Aids.* PPC's *Practice Aids for Audits of Local Governments*, a companion product to this *Guide*, contains Word and Excel versions of all editable practice aids included in that *Guide* that can be easily customized for each engagement.
- *PPC's SMART Practice Aids* bring advanced functionality to the practice aids in that *Guide*, including automatic generation of tailored audit programs based on the risk assessment for each client engagement.
- *PPC's SMART Practice Aids—Single Audit Suite* allows auditors to plan and execute their entire Single Audit engagement from beginning to end—including preparation and electronic signoff of practice aids, federal award programs, and compliance audit programs. In addition, it automates the process of determining major programs, low-risk auditee status, and appropriate compliance requirements, and prepares the compliance audit program and schedule of expenditures of federal awards.
- *Checkpoint Engage* is a fully integrated online audit solution that provides increased audit efficiency and quality.
- *PPC's Workpapers.* PPC's *Workpapers for Local Governments* utilizes advanced diagnostics and dynamically changing content to create electronic workpapers common to government audits and helps you standardize the format of your firm's workpapers.
- *PPC's Disclosure Library.* PPC's *Interactive Disclosure Library for Governments* is an electronic version of the governmental disclosure checklist that provides hundreds of real-world disclosure examples illustrating disclosures required by GAAP that can easily be pasted into governmental financial statements.
- *PPC's Engagement Letter Generator* is interactive software that automates the process of drafting engagement letters.

PPC practice aids assist auditors in complying with professional standards and achieve an efficient workflow. *PPC's Guide to Audits of Local Governments* indicates which practice aids should be completed on each engagement to fulfill specific professional standards. Additionally, it indicates which practice aids generally, by themselves, do not fulfill a specific GAAS, Yellow Book, or Single Audit requirement and which practice aids assist auditors in situations that do not occur on every audit.

The auditor may choose to document audit procedures in a memo or in another form rather than using a PPC practice aid. However, the authors recommend doing so only with caution. Recent peer review findings identify failure to utilize or customize audit programs as a deficiency commonly found in peer reviews of Single Audits. To ensure that the alternative documentation meets GAAS, Yellow Book, or Single Audit requirements, the authors recommend that auditors read the practice aid for an indication of the matters to be considered and documented. As a general rule of thumb, the alternative documentation should address the subtitles in the PPC practice aids, thereby indicating how all the major areas for consideration in the practice aid are addressed. *PPC's Guide to Audit Risk Assessment* contains a case study that illustrates the PPC audit process using a combination of completed PPC practice aids and memos that replace certain practice aids.

SELF-STUDY QUIZ

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

6. What is one way government-wide financial statements differ from fund financial statements?
    a. The statement of net position focuses on each of the government's fund types.
    b. Capital outlays are reported as expenditures.
    c. Net position is classified in three categories.
    d. Fiduciary activities are included but segregated from other activities.
7. Which of the following is included in required supplementary information (RSI) that is presented after the notes to the financial statements?
    a. A budgetary comparison statement.
    b. Schedules and disclosures of infrastructure assets.
    c. A summary reconciliation of the fund and government-wide financial statements.
    d. A summary of significant accounting policies.
8. What basis of accounting is used to record cash receipts and disbursements?
    a. Generally accepted accounting principles (GAAP).
    b. The regulatory basis.
    c. The tax basis.
    d. The cash basis.
9. Which of the following occurs as part of a Single Audit?
    a. The auditor expresses an opinion on the governmental unit's eligibility for federal funds under federal grant program agreements.
    b. The auditor conducts the audit engagement in accordance with GAAS instead of using other standards.
    c. The auditor studies and evaluates the governmental unit's internal control over federal awards programs.
    d. The auditor conducts a compliance audit separately from the governmental unit's financial statement audit.

SELF-STUDY ANSWERS

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

6. What is one way government-wide financial statements differ from fund financial statements? **(Page 187)**

   a. The statement of net position focuses on each of the government's fund types. [This answer is incorrect. The statement of net position and the statement of activities in the government-wide financial statements focus on the government "taken as a whole" rather than on fund types.]

   b. Capital outlays are reported as expenditures. [This answer is incorrect. In the government-wide financial statements, capital outlays for governmental activities are reported as capital assets rather than expenditures. Long-term debt proceeds and principal payments are reported as long-term liabilities rather than as other financing sources and expenditures.]

   c. **Net position is classified in three categories. [This answer is correct. The first group of basic financial statements required by GASBS No. 34 is the government-wide financial statements. These statements are comprised of a statement of net position and a statement of activities. The government-wide financial statements contain significant differences from the fund financial statements, including that net position is classified in three categories—net investment in capital assets, restricted, and unrestricted.]**

   d. Fiduciary activities are included but segregated from other activities. [This answer is incorrect. Fiduciary activities are excluded from the government-wide financial statements because those resources are not available to finance the government's programs.]

7. Which of the following is included in required supplementary information (RSI) that is presented after the notes to the financial statements? **(Page 188)**

   a. A budgetary comparison statement. [This answer is incorrect. RSI includes budgetary comparison schedules for the general fund and each major special revenue fund *with a legally adopted budget,* unless the government elects to include the required information in a budgetary comparison statement as part of the basic financial statements, rather than as RSI.]

   b. **Schedules and disclosures of infrastructure assets. [This answer is correct. RSI, except the MD&A, should be presented immediately after the notes to the financial statements. In addition to MD&A, RSI includes, among other things, supplementary information required under GASBS Nos. 10, 34, 67, 68, 73, 74, 75, and 78, as well as schedules and accompanying disclosures of infrastructure assets. The latter is required only if a government elects to use the modified approach and not depreciate such assets, but if it is included, it would be placed with this RSI.]**

   c. A summary reconciliation of the fund and government-wide financial statements. [This answer is incorrect. A summary to the government-wide financial statements has to be presented at the bottom of the fund financial statements or in an accompanying schedule. Therefore, this would not be part of the RSI.]

   d. A summary of significant accounting policies. [This answer is incorrect. A summary of significant accounting policies based on the requirements of GASBS No. 34 is part of the notes to the financial statements, not the RSI.]

8. What basis of accounting is used to record cash receipts and disbursements? **(Page 189)**

   a. Generally accepted accounting principles (GAAP). [This answer is incorrect. The basis of accounting described above is a special purpose framework, that is, a basis of accounting *other than* GAAP.]

b. The regulatory basis. [This answer is incorrect. This is a basis of accounting that an entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction it is subject.]

c. The tax basis. [This answer is incorrect. This is a basis of accounting that an entity uses to file its tax return for the period covered by the financial statements.]

d. **The cash basis. [This answer is correct. The cash basis is a basis of accounting that an entity uses to record cash receipts and disbursements. The cash basis of accounting includes modifications having substantial support, so either a pure cash basis or a modified cash basis could be presented.]**

9. Which of the following occurs as part of a Single Audit? **(Page 194)**

a. The auditor expresses an opinion on the governmental unit's eligibility for federal funds under federal grant program agreements. [This answer is incorrect. Federal program grant agreements may require grant recipients to obtain program compliance audits. In program compliance audits (not Single Audits), auditors express opinions on (1) the recipient's compliance with the provisions of particular federal grant program agreements and (2) the governmental unit's eligibility for federal funds under those programs.]

b. The auditor conducts the audit engagement in accordance with GAAS instead of using other standards. [This answer is incorrect. Auditors of governmental entities should conduct their engagements in accordance with the AICPA's GAAS. However, when performing a Single Audit, auditors are also responsible for performing the financial audit in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States (the Yellow Book). The Yellow Book incorporates GAAS; neither excludes the other. Auditors would also need to consider the Single Audit Act, among other things.]

c. **The auditor studies and evaluates the governmental unit's internal control over federal awards programs. [This answer is correct. A Single Audit consists of three parts, one of which is a study and evaluation of the governmental unit's internal control over federal awards programs. The Single Audit Act's internal control requirements exceed minimum requirements under GAAS and the Yellow Book.]**

d. The auditor conducts a compliance audit separately from the governmental unit's financial statement audit. [This answer is incorrect. AU-C 935B provides guidance on applying GAAS in a compliance audit. Compliance audits are typically performed in conjunction with the financial statement audit. This is especially true in a Single Audit engagement, in which the auditor is responsible for, among other things, a financial audit and testing the governmental unit's compliance with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major program.]

Lesson 2: Assessing Risks and Developing the Detailed Audit Plan

INTRODUCTION

This lesson focuses on (a) identifying and assessing the risks of material misstatement at the relevant assertion level and (b) preparing a detailed audit plan that appropriately addresses those risks. It also contains a detailed discussion of the auditor's consideration of risks of material misstatement due to fraud.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize best practices for identifying and assessing risks of material misstatement at the relevant assertion level.
- Determine what special considerations apply to the consideration of fraud risks, and how to respond to risk assessment and prepare the detailed audit plan.

Applicable Auditing Requirements

The following standards establish key requirements and provide guidance that affects identifying and assessing risks and developing the detailed audit plan:

- AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*, addresses the identification and assessment of risks that may result in a material misstatement due to fraud, along with fraud risk factors. It sets forth the presumption that improper revenue recognition is a fraud risk in all audits and the requirement to address the risk of management override of controls. It also provides documentation requirements regarding identified fraud risks and the response to such risks.
- AU-C 300B, *Planning an Audit*, sets forth the requirement to establish an audit plan and describes the components of the audit plan.
- AU-C 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes the requirements for the identification and assessment of risks at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures. It also addresses significant risks and risks for which substantive procedures alone do not provide adequate audit evidence. It also sets forth documentation requirements for identifying and assessing risks.
- AU-C 320B, *Materiality in Planning and Performing an Audit*, defines the audit risk model, including the components of inherent, control, and detection risk along with the risk of material misstatement. It also sets forth the requirement to assess risk at the relevant assertion level as a basis for further audit procedures.
- AU-C 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, provides the requirement to design and perform further audit procedures that are responsive to assessed risk of material misstatement at the relevant assertion level (along with describing overall responses to risks at the financial statement level). It also provides documentation requirements for responses to risks at the financial statement level; the nature, timing, and extent of further audit procedures; the linkage of procedures to assessed risks; and the results of audit procedures.
- AU-C 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements for auditing fair value estimates.
- AU-C 550, *Related Parties*, establishes requirements regarding related party relationships and transactions.

- AU-C 935B, *Compliance Audits*, addresses the application of GAAS to a compliance audit, i.e., when an auditor is engaged, or required by law or regulation, to perform an audit of a governmental unit's compliance with applicable compliance requirements.

In the period from May 2019 to April 2020, the ASB issued SAS Nos. 134 to 140, which were discussed in Lesson 1. In May 2020, the ASB released SAS No. 141, *Amendments to the Effective Dates of SAS Nos. 134-140*, that delayed the effective dates of those standards to provide audit firms more time to implement them in light of the COVID-19 pandemic. The revised effective dates for these SASs are for audits of financial statements for periods ending on or after December 15, 2021. Early implementation is permitted, but the ASB recommends that the reporting standards, SAS Nos. 134, 136, 137, 139, and 140, be implemented concurrently, as a suite, to accommodate the transition to the new audit reporting model implemented by SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. Specific changes made by SAS Nos 134 and 135 are described in this lesson in relation to the guidance they affect.

In August 2020, the AICPA issued an exposure draft, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The proposed SAS would supersede AU-C 315B and amend other auditing standards related to risk assessment. It is intended to enhance the auditor's ability to appropriately understand the entity's system of internal control, in particular relating to the auditor's work effort to obtain the necessary understanding, and determine risks of material misstatement, including significant risks. The revisions would also modernize the standard in relation to information technology considerations, including addressing related risks. The proposed standard introduces several new concepts and definitions related to inherent risk assessment and significantly enhanced the related requirements. The effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2023. Future editions of this course will be updated for any new developments. Readers can follow this project at **www.aicpa.org**.

Identify and Assess Risks at Two Levels

To provide a basis for designing and performing both tests of controls and substantive procedures (collectively, further procedures), AU-C 315B.26 requires the auditor to identify and assess the risks of material misstatement at (a) the financial statement level, and, (b) for classes of transactions, account balances, and disclosures, at the relevant assertion level. Identifying and assessing the risks at both of these two levels is necessary. Though outside of the scope of this course, general planning, including identifying, assessing, and responding to the risks of material misstatement at the financial statement level, is discussed in *PPC's Guide to Audits of Local Governments*. This lesson focuses on identifying, assessing, and responding to the risks of material misstatement at the relevant assertion level.

After identifying risks of material misstatement throughout the process of obtaining an understanding of the entity and its environment (including relevant controls that relate to the identified risks), as explained in more detail later in this lesson, the auditor has to evaluate how the identified risks relate to the two levels. What classes of transactions, account balances, and disclosures are affected by the identified risks? Do the identified risks relate more pervasively to the opinion unit financial statements as a whole, and potentially affect many assertions, or do they affect particular relevant assertions of the classes of transactions, account balances, and disclosures to which they relate? Some risks of material misstatement, such as management override of controls, may be pervasive and give rise to risks of material misstatement at both the opinion unit financial statement level and for particular relevant assertions for particular transaction classes, account balances, or disclosures. For example, a risk of management override may give rise to risks of material misstatement related to the occurrence assertion for revenue transactions.

In 2018, the AICPA Peer Review Board reported that approximately 10% of firms were deemed to have nonconforming engagements due to noncompliance with the risk assessment requirements in AU-C 315B. To arrive at this, the AICPA analyzed more than 400 peer review Matters for Further Consideration (MFCs) from 2016 and found that more than one in 10 firms were not properly assessing risk or linking their assessments to further audit procedures planned and performed. There was an incomplete or nonexistent risk assessment in 14%, and a failure to adequately link the risk assessment and response in 24%. The failure to obtain an understanding of internal control when identifying a client's risks accounted for 40% of identified issues. In 13% of identified issues, there was an assessment of control risk as less than high without applying tests of controls. In their most recent peer review findings report, risk assessment matters continue to be an issue.

FINANCIAL STATEMENT ASSERTIONS

Assertions are what management is saying, either explicitly or implicitly, about the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. AU-C 315B.04 defines *assertions* as "representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of potential misstatements that may occur." AU-C 315.A133, as amended by SAS No. 134, explains that assertions used by the auditor fall into the following categories:

- Assertions about classes of transactions and events, and related disclosures, for the period under audit.
- Assertions about account balances, and related disclosures, at period end.

AU-C 315.A133, as amended by SAS No. 134, identifies the individual assertions within these categories that are explained below. In addition to these assertions about the financial statements, management of a governmental entity asserts that transactions and events have been carried out in accordance with law or regulation, and that such assertions may fall within the scope of the financial statement audit.

Assertions about Classes of Transactions

Assertions about transaction classes and events, and related disclosures, for the entire period under audit and include the following:

a. *Occurrence.* Transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.

b. *Completeness.* All transactions and events that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.

c. *Accuracy.* Amounts and other data relating to the recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

d. *Cutoff.* Transactions and events have been recorded in the correct accounting period.

e. *Classification.* Transactions and events have been recorded in the proper accounts.

f. *Presentation.* Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about Account Balances

Assertions about account balances and related disclosures at the end of the period include the following:

a. *Existence.* Assets, deferred outflows of resources, liabilities, and deferred inflows of resources exist.

b. *Rights and Obligations.* The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

c. *Completeness.* All assets, deferred outflows of resources, liabilities, and deferred inflows of resources that should have been recorded have been recorded, and related disclosures that should have been included in the financial statements have been included.

d. *Accuracy, Valuation, and Allocation.* Assets, deferred outflows of resources, liabilities, deferred inflows of resources, fund balances, and net position have been included in the financial statements at appropriate amounts, any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

e. *Classification.* Assets, deferred outflows of resources, liabilities, deferred inflows of resources, fund balances, and net position have been recorded in the proper accounts.

f. *Presentation.* Assets, deferred outflows of resources, liabilities, deferred inflows of resources, fund balances, and net position and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

An entity may be required or may elect to make disclosures not directly related to recorded classes of transactions, events, or account balances, such as exposures to risks arising from financial instruments or the objectives and methods for measuring and managing the risks. AU-C 315.A134, as amended by SAS No. 134, indicates that the assertions for transaction classes, events, and account balances may be adapted to consider the different types of potential misstatements that may occur in such disclosures.

Relevant Assertions

AU-C 315B.04 defines a *relevant assertion* as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." Determination of whether an assertion is relevant is made without regard to the effect of internal controls. A routine example is that the valuation assertion is usually not relevant to the cash account unless currency translation is involved. Another example is that the valuation assertion is usually not relevant to the gross amount of the accounts receivable balance, but is usually relevant to the related allowance for uncollectible accounts. Additionally, the valuation and rights or obligations assertions are generally not directly relevant to the operating statement accounts. Those assertions generally relate to statement of position accounts that may well affect the operating statement, but not to operating statement accounts directly.

Auditors focus on those assertions that have some realistic chance of being misstated. The identification and assessment of risks of material misstatement made to prepare the audit plan and determine the nature, timing, and extent of further procedures are made at the relevant assertion level. For example, AU-C 315B.27 requires the auditor to relate identified risks to what can go wrong at the relevant assertion level taking into account relevant controls the auditor intends to test. In other words, relating controls to assertions by identifying controls that are likely to prevent, or detect and correct, material misstatements in specific assertions is required if the auditor plans to rely on controls. References to "decisions made at the relevant assertion level" mean decisions made about the relevant assertions within a particular class of transactions, account balance, or disclosure.

For each significant class of transactions, account balance, and disclosure, the auditor determines the relevance of each financial statement assertion. AU-C 315B.A132 indicates that relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertions.

By determining the relevance of assertions for an account balance, class of transactions, or disclosure and how identified risks relate to them, the auditor can effectively design and link further audit procedures that are responsive to the assessment of the risks of material misstatement.

Assertion Categories Using the PPC Approach

AU-C 315B.A129 notes that the auditor may use the relevant assertions as they are described in AU-C 315B.A133 and the preceding paragraphs or may express them differently provided aspects described therein have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

To facilitate the assessment of risks at the assertion level, the authors recommend the following categories of assertions, which are integrated in the PPC audit approach:

a. Existence or occurrence (E/O).

b. Completeness (C).

c. Rights or obligations (R/O).

d. Valuation or allocation (V).

e. Accuracy or classification (A/CL).

f. Cutoff (CO).

Various audit programs in *PPC's Guide to Audits of Local Governments* use the symbols following each category of assertion to identify which assertion or audit objective a particular audit procedure is directed to achieving. There are no separate categories or related symbols in the PPC audit approach similar to the categories of assertions described in the application guidance in AU-C 315.A133, as amended by SAS No. 134, related to matters of presentation or disclosures. The PPC audit approach addresses disclosure and presentation related matters in the Concluding Audit Steps of the individual audit area programs and in the General Audit and Completion Program and includes the presentation assertion with the A/CL assertion.

The primary matters related to presentation or to disclosure considered in audit programs for individual audit areas are: the proper classification of accounts for financial statement presentation; ensuring that the workpapers include the information that supports disclosures and that such information has been subjected to appropriate audit procedures; and agreeing or reconciling the financial statements to the general ledger. The completeness and understandability of disclosures are also considered in the audit work related to the process of preparing the financial statements, that is, in the general audit program. For example, the completeness of disclosures is considered by using a disclosure checklist along with evaluating whether, based on the auditor's knowledge of the client's business and industry, there are other matters of importance that should be disclosed, including whether additional information is necessary to make the disclosed information not misleading. The understandability or clarity of disclosures, as well as matters of occurrence, are considered by a careful review of the financial statements and disclosures in light of the auditor's knowledge gained throughout the audit. The general auditing and completion programs (contain procedures related to those aspects of presentation or disclosure.

These categories cover both of the categories of assertions for transactions and events as well as account balances. For example, the authors use the following audit objective in the general audit program to encompass the remaining assertions about presentation and disclosure that are considered in the process of preparing the financial statements: "Financial statements are presented in accordance with GAAP (or a special purpose framework). Required disclosures are complete, clearly expressed and understandable, and contain financial and other information that is fairly disclosed at appropriate amounts."

THE IDENTIFICATION OF RISKS OF MATERIAL MISSTATEMENT AT THE RELEVANT ASSERTION LEVEL

AU-C 315B.26 requires that for the purpose of designing and performing further audit procedures, the auditor should identify and assess risks of material misstatement at both the financial statement level and the relevant assertion level. A discussion of the identification and assessment of these risks at the financial statement level during general planning is beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Local Governments*. This lesson focuses on identifying and assessing the risks of material misstatement at the relevant assertion level related to account balances, transaction classes, and disclosures. For that purpose, AU-C 315.27, as amended by SAS No. 134, requires the auditor to do the following:

a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks and by considering the classes of transactions, account balances, and disclosures (including quantitative and qualitative aspects of such disclosures) in the financial statements.

b. Assess the identified risks and evaluate whether they potentially affect many assertions because of their pervasive effect on the financial statements.

c. Relate the identified risks to what can go wrong at the relevant assertion level, considering relevant controls to be tested.

d. Consider the likelihood that the risks, including the potential for multiple misstatements, could result in a misstatement of the financial statements.

e. Consider whether the potential misstatement could result in a material misstatement of the financial statements.

Risk assessment procedures are performed to gather information to be used as audit evidence to support the auditor's assessment of risks of material misstatement, which affects the nature, timing, and extent of further procedures (tests of controls and substantive procedures). The focus of this section is primarily on the process of gathering information to identify risks, considering how those risks relate to classes of transactions, account balances, and disclosures, and evaluating whether the risks relate more pervasively to the opinion unit financial statements (items a. and b. above and AU-C 315B.27). The information gathering process also inevitably involves consideration of some aspects of items c. and d. because the ultimate objective of gathering the information through performing risk assessment procedures is to design further procedures that are linked to and responsive to the risks identified. Items c. through d. are discussed in more detail later in this lesson.

As indicated in the corresponding application guidance (AU-C 315B.A139-A.146) of items a. and c. above and AU-C 315B.27, the information gathered includes obtaining an understanding of controls sufficient to evaluate the design of the controls and to determine whether they have been implemented to support the preliminary assessment of control risk for each relevant assertion, and consider whether further procedures will include tests of controls. An auditor relates control activities to assertions and identifies those that are likely to prevent, or detect and correct, material misstatement in specific assertions. Tests of controls are not made unless an auditor believes the controls are designed and implemented effectively and that relying on the controls would be efficient and effective. Even when an auditor does not plan to rely on controls, evaluating design and determining implementation are required. The assessment of control risks as part of assessing risks of material misstatement is also discussed in more detail later in this lesson.

The auditor's identification of risks is a matter of professional judgment and requires more than reviewing a checklist of risk factors or red flags. It necessitates bringing to bear all of the auditor's knowledge, including knowledge obtained about the entity and its environment, its management, the political and social climate in which it operates, its internal control, and risk factors. Prior to performing risk identification, information gathered is merely information that *may* be relevant in identifying risks. This is because the presence of risks may only become evident when information from different sources is combined. For instance, seemingly unrelated information might indicate a potential risk only when analyzed in combination or as a whole. The authors believe an auditor needs to combine, or synthesize, information gathered to identify the areas where the entity's financial statements are susceptible to material misstatement due to error or fraud. When analyzed in combination or as a whole, seemingly unrelated information might indicate a potential risk. In addition, it is difficult to link risks with responses unless the risks are stated in terms of their potential effects on the financial statements.

Gathering Information from Risk Assessment and Other Planning Procedures

Though outside of the scope of this course, *PPC's Guide to Audits of Local Governments* provides an in-depth discussion of the procedures performed to obtain an understanding of the entity and its environment, including its internal control, and the information that is gathered throughout that process to identify risks of material misstatement. Information is gathered from a variety of sources by performing the following risk assessment and other planning procedures:

- Planning and preliminary engagement activities, including—
  - Acceptance and continuance procedures.
  - Establishing an understanding with the client.

- Obtaining an understanding of the entity and its environment, including its internal control, by performing—
  - Inquiries of management and others (including required fraud inquiries).
  - Observation and inspection (including review of governing board minutes).
  - Identification of fraud risk factors.
- Discussion among engagement team members.
- Preliminary analytical review.
- Review of interim financial statements, if applicable.
- Other planning procedures.

When gathering information that may be relevant to identifying risks, some auditors may be tempted to prematurely dispose of information that might suggest potential risk indicators. The authors believe it is important to avoid the temptation to dispose of individual pieces of information without considering them in the context of all the information gathered. When auditors perform risk assessment procedures to gather information, that information has not yet been evaluated to determine how it relates to the financial statements and what could go wrong. At that point, the information gathered is essentially "raw material." The authors believe further processing of that raw material is necessary before potential risks of material misstatement can be identified. The authors believe the auditor applies professional judgment to combine, or synthesize, information gathered to identify the areas where the entity's financial statements may be susceptible to material misstatement due to error or fraud. Once the auditor understands what can go wrong in the financial statements, he or she can develop an appropriate response to such risks.

Information the auditor collects for further evaluation does not necessarily represent a risk of material misstatement of the financial statements, nor does the information necessarily require an audit response. It is merely information that suggests a potential risk indicator. The information may represent a risk of material misstatement and require an audit response, or it may not. Therefore, auditors need not be concerned that accumulating too much information will result in audit inefficiency.

Specialized Considerations for Governmental Units

Auditors need to consider risks associated with the COVID-19 pandemic as they plan and perform their audit, including obtaining or updating their understanding of the entity and its environment and identifying risks. The impact of the COVID-19 pandemic will likely affect the entity's environment, regulatory, and other external factors. The entity's operations could also be significantly affected by its ability to deliver on its services and commitments. The volatile financial markets could impact the valuation of the entity's investments and financing sources. Further, the impact of COVID-19 has probably affected the comparability of information regarding the entity's operations, industry conditions, financial results, nonfinancial measures, etc. Updated information and financial statement considerations related to the COVID-19 pandemic are available at **checkpoint.riag.com** and **www.thomsonreuters.com**.

During the process of identifying risks unique to governmental units that could affect the opinion unit financial statements, the auditor considers questions such as the following:

- Does the governmental unit rely heavily on income from a single source (such as income, sales, or property taxes), and how likely is it that these sources might be negatively impacted (such as due to a poor economy)?
- Are bond rating agencies considering changing the governmental unit's bond rating?
- Have there been changes in the terms or volume of the governmental unit's federal awards (for example, are the awards suddenly for shorter terms or are the awards being phased out, did the government unit receive COVID-19-related funding)?
- What were the results of grantor agency reviews?

- Have changes in the local economy affected major taxpayers or major utility customers?

Past experience with the client is one of the primary ways of identifying the risk of misstatement from error. For example, does the government maintain current accounting policies and procedures manuals? Are reports required by state or federal agencies submitted on a timely basis? Are internal control weaknesses or compliance findings from previous audits resolved on a timely basis? Does the government maintain its day-to-day accounting records on a cash basis and convert the financial statements to a GAAP basis only at year end? Any time a governmental unit does not follow GAAP during the year and attempts to record material correcting entries at year end, there is an increased risk that the financial statements will be materially misstated.

The competence of accounting personnel and the quality of the accounting and financial reporting system are the other primary sources of information on the risk of misstatement arising from error. Employee training and skills can affect the effectiveness of internal control, particularly for smaller governments. Accounting is sometimes seen as less important than serving the citizens. In some instances, the pressure to lower taxes may prevent the government from having a sufficient number of employees to permit an adequate segregation of duties. Also, lower pay scales may result in the government hiring accounting and bookkeeping personnel with limited accounting education or experience. Similarly, rapid employee turnover can mean that replacements may not receive adequate training.

Consideration of Opinion Units. It is important to remember that in the audit of a governmental unit, the auditor's risk assessment activities need to take into account the government's various opinion units. This is because auditors issue an opinion on each opinion unit instead of the entity as a whole.

Synthesizing the Information

Once auditors have accumulated information relevant to the identification of potential risks, the information is evaluated together. Auditors apply professional judgment to determine whether the information gathered during the risk assessment process, either individually or in the aggregate, indicates areas where the entity's financial statements might be susceptible to material misstatement (whether due to error or fraud). The authors refer to this process as *synthesis*. Synthesis is a mental process involving analysis of the information gathered to identify risks.

Why Is Synthesis Important? The synthesis process helps the auditor—

- Recognize how the pieces of information gathered, alone or in combination, could indicate circumstances where risks might exist.
- Evaluate whether the circumstances could potentially result in material misstatement of the financial statements.
- Articulate those circumstances in terms of what could go wrong at the relevant assertion level.

Only after the auditor can clearly articulate the risks can he or she ordinarily assess the risks and develop appropriate responses.

There may not be a one-to-one relationship between the pieces of information gathered and risks of material misstatement of the financial statements but combining seemingly unrelated information indicates a risk. In other cases, one piece of information, in and of itself, may represent a condition that indicates a risk. Further, the totality of the information gathered, when synthesized, could actually lead to the identification of an overall risk at the financial statement level, such as a lack of personnel with appropriate accounting and financial reporting skills. The synthesis process may be compared to putting a jigsaw puzzle together. It may be difficult to tell from looking at an individual puzzle piece what the picture will be. However, as pieces are put together one by one, an image begins to take shape. When the puzzle is finished, the pieces form a picture.

Synthesis Considerations. Synthesis of the information gathered during the performance of risk assessment and other planning procedures allows auditors to identify risks that might be associated with seemingly unrelated information. To synthesize the information and identify risks, auditors consider the information in the context of—

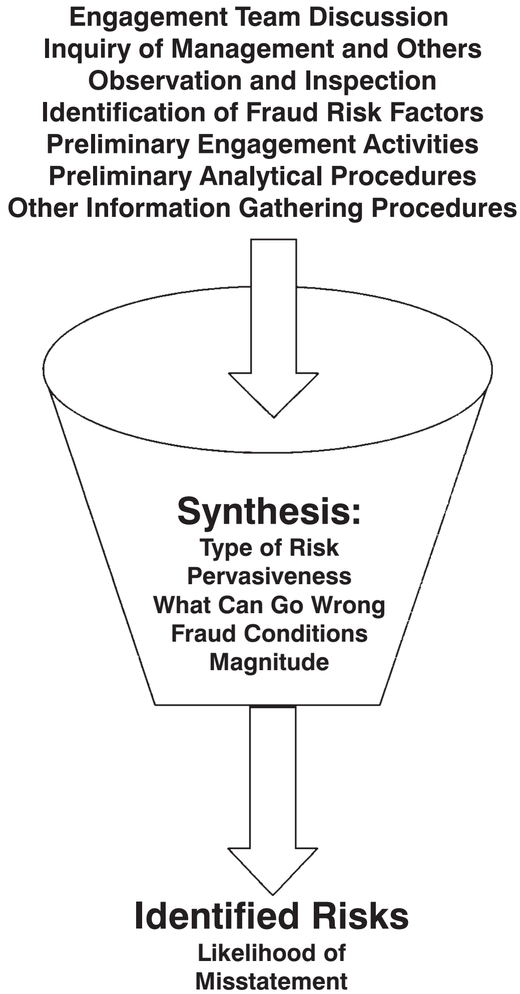
- The broad type of risk (that is, whether it relates to error or fraud).
- The pervasiveness of the risk, that is, whether the risk is—
  - Pervasive to the financial statements taken as a whole.
  - Related to a relevant assertion(s) for specific classes of transactions, account balances, or disclosures.
- What can go wrong at the relevant assertion level (that is, how the potential risk could affect specific assertions related to account balances, transaction classes, or disclosures).
- If the risk is a fraud risk, including whether any of the three conditions generally present when fraud occurs (that is, incentives/pressures, opportunities, and attitudes/rationalizations) and the extent to which those conditions have been observed.
- The likelihood of a misstatement and whether that potential misstatement could result in material misstatement of the opinion unit financial statements.

After the information is synthesized and the risks of material misstatement are identified, the likelihood of the risks resulting in material misstatement is then assessed. The assessment of likelihood is a function of the assessed levels of inherent and control risk, which are discussed later in this lesson.

Exhibit 2-1 includes a visual representation of the types of information gathered during the risk assessment process and the synthesis of that information. The identification of risks may also be influenced by the specific characteristics of the entity, such as its size, complexity, and governance attributes. The following paragraphs discuss the primary considerations in performing the synthesis to identify risks. Each of the auditor's considerations is discussed separately, but the considerations may occur simultaneously.

Exhibit 2-1

The Synthesis Process



Considering the Effect of the Potential Misstatement. Considering the effect of a potential misstatement in accordance with AU-C 315, as amended by SAS No. 134, includes consideration of both quantitative and qualitative aspects. (SAS No. 134 provides clarifying guidance on considering the effect of potential misstatements.). For example, for a risk related to a potential underaccrual of an entity's allowance for doubtful accounts, materiality is primarily quantitative. That is, could the allowance for doubtful accounts be underestimated by such an amount that the financial statements could be materially misstated? However, consideration also needs to be given to the qualitative aspects of potential misstatements. In certain cases, qualitative aspects of potential misstatements that might be immaterial could be considered material to financial statement users. For example, a risk of misstatement that could also have an effect on other financial statement components needs to be more carefully considered. AU-C 450, as amended by SAS No. 134, states that auditors need to consider qualitative misstatements by nature or circumstances that could cause information in the financial statements to be misleading to users. Considering the effect of potential misstatements is illustrated in the following examples.

Example 2-1: Considering materially of a potential misstatement.

While performing risk assessment procedures, the auditor of the Tall Trees Town identifies a risk of understatement of accounts payable due to a lack of accrual of invoices payable at year end. Because the auditor is aware of a number of significant purchases made by the entity just prior to the end of the year, he determines that the magnitude of the understatement of accounts payable could be such that the potential misstatement could be material to the financial statements.

When evaluating the effect of potential misstatements from fraudulent financial reporting risks, qualitative considerations are particularly important because the fraud involves intentional deception of financial statement users. A common belief is that fraudulent misstatement of financial statements is by definition material. The reasoning goes that because the goal of the fraud is to deceive users of the financial statements, the fraud would have to be material to influence the judgment of the user. However, that does not necessarily mean the fraudulent misstatement would have to be quantitatively large. The authors believe that if the auditor gathers information that results in identifying a potential fraud risk related to manipulation of the financial statements, it is unlikely the auditor would conclude that the matter is not material to financial statement users.

Synthesis Questions. Exhibit 2-2 provides a list of questions auditors can ask to help determine whether the information gathered, individually or in combination, indicates a potential risk of material misstatement of the financial statements.

Exhibit 2-2

Synthesis Questions

What Type of Risk Exists?

- Does the risk relate to error or fraud?
- If the risk is a fraud risk, does it relate to misappropriation of assets or fraudulent financial reporting?

Is the Risk Pervasive?

- Is the risk confined to an assertion(s) relating to a particular account balance, transaction class, or disclosure?
- Is the risk of such a nature that multiple financial statement components could be affected?

What Can Go Wrong at the Assertion Level?

- What could the risk cause to go wrong in the financial statements?
- What opinion units would be affected by the risk?
- What account balance, transaction class, or disclosure in the financial statements would be affected by the risk?
- What assertion does the risk relate to?
- What is the direction of the risk (that is, overstatement or understatement)?

For Risks of Error:

- Is there a past history of errors relating to the assertion and account balance, transaction class, or disclosure?
- Are there indications that the account balance, transaction class, or disclosure is susceptible to error?
- Are there existing conditions or control weaknesses that make the entity vulnerable to error for this assertion and account balance, transaction class, or disclosure?
- Are there any indications that errors may have occurred in the current period relating to the assertion and account balance, transaction class, or disclosure?

For Risks of Fraudulent Financial Reporting:

- What incentives or pressures exist for management to misstate the financial statements (e.g., pressures to provide more services without raising taxes, or to manipulate amounts related to debt covenants or declining financial condition of major taxpayers)?
- Is there ineffective oversight of management or does management fail to adequately monitor internal controls over the financial reporting process?
- Does management communicate inappropriate values or ethics?
- Does management display domineering behavior towards the auditor, especially involving attempts to influence the scope of the auditor's work or the auditor's judgment about the appropriateness of the selection and application of accounting principles?
- Are there any other indications that management might be manipulating the financial statements?

For Risks of Misappropriation of Assets:

- Which assets are most susceptible to misappropriation?
- What conditions exist that might make the entity vulnerable to misappropriation?
- Are there any indications that misappropriation might be occurring?

Could the Risk Result in a Material Misstatement of the Financial Statements?

- Could the risk result in a misstatement such that an opinion unit's financial statements as a whole could be materially misstated?
- Are there additional qualitative considerations that ought to be considered in determining whether the misstatement could be material to the opinion unit financial statements?

Identifying Risks of Material Misstatement

Articulating Risks. The output of the synthesis process is the articulation of identified risks and the assertions affected. Risks generally are stated in terms of what can go wrong in the financial statements at the relevant assertion level. To assist in assessing risks and determining further audit procedures to be performed, the authors recommend that auditors be as specific as possible when describing risks. The authors recommend that a well articulated risk describe—

- The cause of the risk.
- Which opinion unit(s) may be affected.
- The account balance, class of transactions, or disclosure and how it may be affected.
- If a fraud risk, the type of risk (misappropriation of assets or fraudulent financial reporting).
- The relevant assertion (or that it is an overall financial statement risk).

The assessment of identified risks and selection of appropriate responses can be a more effective process if the identified risks are well-articulated, as illustrated in the following example.

Example 2-2: Identifying a risk—putting it all together.

While gaining an understanding of the entity and its environment, the auditor of Hillwood Village identifies the potential risk created by the fact that Hillwood's tax base is declining due to financial difficulties of major commercial taxpayers. The auditor relates that risk to what could go wrong at the assertion level as being a risk of overstatement of taxes receivable associated with valuation. The auditor then considers that, given the size of the receivable balance and the number and size of taxpayers that potentially would be unable to meet their obligations, the potential misstatement could result in material misstatement of Hillwood's governmental activities and general fund opinion units. As a result, the auditor identifies a valuation risk due to uncollectible accounts that could result in an overstatement of taxes receivable.

Examples of Synthesis. Because synthesis requires professional judgment, auditors may identify different risks based on similar information depending on the client's specific circumstances. Exhibit 2-3 provides examples of how information gathered from various sources may be synthesized to identify risks of material misstatement. As illustrated in the exhibit, there may or may not be a one-to-one relationship between the information gathered and the risks identified. *PPC's Guide to Audit Risk Assessment* provides examples of what can go wrong in the financial statements for inventory, accounts receivable, and accounts payable and other liabilities.

Exhibit 2-3

Examples of Risks Identified through Synthesis

<table>
<tr><th>Source of Information</th><th>Information Gathered</th><th>Identified Risk</th></tr>
<tr><td>Understanding the entity and identifying risks:
• Nature of the entity (operations)
• Objectives and strategies
• Internal control (risk assessment)</td><td>The city created its own fire department staffed by relatively inexperienced firefighters.</td><td rowspan="3">Understatement of the legal liability contingency reserve

(Completeness)</td></tr>
<tr><td>Understanding the entity and identifying risks—Internal control (monitoring activities)</td><td>Water and sewer customers' complaints about improper billing are not adequately captured and monitored.</td></tr>
<tr><td>Understanding the entity and identifying risks:
• Nature of the entity (financial reporting)
• Inquiry of management
• Inquiry of outside legal counsel</td><td>A lawsuit was filed against the city for failure to install a traffic light at an intersection with frequent accidents and some fatalities.</td></tr>
<tr><td>Understanding the entity and identifying risks—Internal control (control activities)</td><td>Controls over the pension expense calculation are weak.</td><td>Overstatement or understatement of pension expense due to calculation errors (Accuracy)</td></tr>
<tr><td>Understanding the entity and identifying risks:
• Nature of the entity (operations)
• Identification of fraud risk factors</td><td>The entity has a significant amount of valuable, but small computer equipment.</td><td rowspan="2">Overstatement of equipment due to misappropriation (Existence)</td></tr>
<tr><td>Understanding the entity and identifying risks—Internal control (control activities)</td><td>The entity has poor physical safeguards over assets.</td></tr>
</table>

Source of Information	Information Gathered	Identified Risk
Understanding the entity and identifying risks: • Nature of entity (financial reporting) • Objectives and strategies • Inquiries of management • Internal control (risk assessment, monitoring and control activities)	The chief financial officer left the entity at the beginning of the year and the entity does not currently have a competent chief financial officer to oversee the financial reporting function.	Overall financial statement risk (which requires an overall response)
Understanding the entity and identifying risks—Internal control (control activities)	There is a lack of segregation of duties within the payroll function.	Overstatement of payroll expense due to misappropriation of assets (Occurrence)
Understanding the entity and identifying risks: • Nature of the entity (investments, financing, financial reporting) • Objectives and strategies • Inquiry of management and others within the entity • Internal control (control activities)	The entity entered into an interest rate swap for the first time during the year.	Overstatement or understatement of liabilities and equity due to improper derivatives accounting and potential violation of laws and regulations (Valuation)

Documenting Identified Risks

AU-C 315B.33 specifies the documentation requirements relating to understanding the entity and its environment and assessing the risks of material misstatement. The auditor is required to document key elements of the understanding; sources of information from which the understanding was obtained; the risk assessment procedures performed; and the assessment and identification of risks of material misstatement, both at the financial statement level and the relevant assertion level. At the relevant assertion level, risks of material misstatement include those that require special audit consideration (significant risks) and those for which substantive procedures alone do not provide sufficient appropriate evidence. AU-C 240B.43 further requires the auditor to document the identified and assessed risks of material misstatement due to fraud that are identified. In addition, if the auditor does not identify improper revenue recognition as a fraud risk, AU-C 240B.46 requires that documentation include the reasons supporting that conclusion. Risks that require special audit consideration and those for which substantive procedures alone do not provide sufficient appropriate evidence and fraud risks are further discussed later in this lesson.

Exhibit 2-4 lists numerous sources from which relevant information may be gathered for risk identification. Auditors may choose to use PPC practice aids, such as those provided in *PPC's Guide to Audits of Local Governments*, in obtaining and documenting such information. Such practice aids are provided as tools the auditor can use when performing risk assessment and other planning procedures to gather information. However, the auditor may choose to perform and document such procedures by other means, such as with narrative descriptions, flowcharts, or decision tables.

Exhibit 2-4

Information Gathered through Risk Assessment and Other Planning Procedures

Risk Assessment/ Other Planning Procedures
Obtaining an understanding of the entity and its environment, including internal control, through: • Inquiries of management and others • Observation and inspection • Identification of fraud risk factors
Discussion among engagement team members
Planning and preliminary engagement activities: • Establishing an understanding with the client • Acceptance and continuance procedures
Preliminary analytical procedures
Reviews of interim financial statements, if applicable

Auditors can document identified risks, as well as the assessed levels of inherent risk, control risk, combined risk of material misstatement for each relevant assertion and appropriate further audit procedures selected, on the practice aids provided in *PPC's Guide to Audits of Local Governments*. There is no requirement to document the synthesis process. The extent of documentation of the process auditors use to synthesize the information gathered to identify risks is a matter of professional judgment. The format and extent of the documentation may be influenced by the nature, size, and complexity of the entity.

Further Assessing Identified Risks

Once the auditor performs the synthesis process and identifies risks of material misstatement, those risks need to be further assessed. Based on that assessment, the auditor will determine the nature, timing, and extent of further auditing procedures to be performed to reduce audit risk to an appropriately low level..

ASSESSING THE RISKS OF MATERIAL MISSTATEMENT IDENTIFIED AT THE RELEVANT ASSERTION LEVEL

AU-C 200B.19 and the AICPA Audit and Accounting Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide), note that auditors should perform audits to obtain reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. AU-C 200B.06 indicates that reasonable assurance is a high, but not absolute, level of assurance. The auditor's consideration of audit risk at the individual account balance, transaction class, or disclosure level directly assists the auditor in determining the nature, timing, and extent of further audit procedures for relevant assertions related to balances, classes of transactions, or disclosures.

The previous section discussed how the auditor gathers information from the risk assessment procedures and other procedures to identify the risks of material misstatement of the opinion unit financial statements whether due to error or fraud. It also discussed how the auditor relates the identified risks to what can go wrong at the relevant assertion level, as well as how the auditor considers whether the risks relate to a potential misstatement of a magnitude that could result in a material misstatement of the financial information for the opinion unit. To assess risks of material misstatement at the assertion level, the auditor has to consider the likelihood that the identified risks could result in a material misstatement of the financial information for the opinion unit. Likelihood is a function of the assessed levels of inherent and control risks, which are discussed in this section.

The consideration of fraud risk as part of the assessment of risks of material misstatements is discussed later in this lesson. The auditor's consideration and identification of risks of material misstatement due to fraud under the requirements of AU-C 240B are not separate from consideration of audit risk; rather, it is integrated into the overall audit risk assessment process described in this course.

The auditor needs to apply the following basic concepts to perform the assessment of risks of material misstatement at the assertion level:

- Financial statement assertions.
- The audit risk model.
- The risk of material misstatement.

The Audit Risk Model

AU-C 200B.14 describes audit risk and its components. AU-C 200B.14 defines *audit risk* as "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated." It further explains that *audit risk* is a function of the risks of material misstatement and detection risk. AU-C 200B.14 defines these terms as follows:

- *Risk of Material Misstatement.* The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:
  - •• *Inherent Risk.* The susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - •• *Control Risk.* The risk that a misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- *Detection Risk.* The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

The audit risk model can be expressed in formula form using the following symbols:

- RMM—Risk of Material Misstatement
- IR—Inherent Risk
- CR—Control Risk
- DR—Detection Risk

DR is determined by the effectiveness of the nature, timing, and extent of procedures applied and is composed of the following two components:

- TD—Tests of Details Risk
- AP—Substantive Analytical Procedures Risk

Risks of Material Misstatement

The combined effect of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, the aggregate risk of material misstatement in the risk model is expressed as follows:

$$RMM = IR \times CR$$

The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately low level. Fraud risks affect both inherent and control risk. Therefore, the auditor's assessments of inherent and control risk include consideration of the risk of material misstatement due to fraud.

Inherent risk and control risk are the entity's risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's combined assessment of the two risks. The auditor may make an overall, or combined, assessment of the risk of material misstatement at the relevant assertion level or make separate assessments of inherent risk and control risk and then combine them. In either approach, the AICPA Risk Assessment Audit Guide (paragraph 5.22) cautions the auditor to asses both components.

Assessing the Risks of Material Misstatement at the Relevant Assertion Level

The risks of material misstatement may be assessed in quantitative or qualitative terms. The assessment at the relevant assertion level, whether made in quantitative terms (e.g., percentages) or nonquantitative terms (e.g., high, moderate, or low), is a judgment rather than a precise measurement of risk. The auditor needs to have an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, and, if applicable, through the performance of suitable tests of controls.

PPC Approach. PPC's audit approach involves the following steps to assess the risks of material misstatement at the relevant assertion level:

- Identify any documented risks of material misstatement at the opinion unit financial statement level that affect the risks of material misstatement for particular account balances, transaction classes, or disclosures.
- Determine those audit areas that are significant.
- Describe the specific risks of material misstatement by relevant assertion for each account balance, transaction class, or disclosure within each significant audit area and evaluate the nature and level of the specific risks.
- Make a qualitative assessment of inherent risk as high, moderate, or low for each relevant assertion.
- Make a qualitative evaluation of control risk as high, moderate, or low for each relevant assertion.
- Make a qualitative assessment of the combined risk of material misstatement as high, moderate, or low for each relevant assertion based on the evaluations of inherent risk and control risk.

Using PPC's audit approach, the auditor's risk assessment at the assertion level is performed and documented using Part II of the "Risk Assessment Summary Form" (which is included in PPC's Guide to Audits of Local Governments). That form is used to (a) identify significant audit areas and affected assertions; (b) identify fraud risks and other significant risks; (c) document the auditor's assessment of inherent risk, control risk, and combined risk of material misstatement at the assertion level; and (d) select an audit approach that is responsive to the assessed level of risk at the relevant assertion level and to clarify linkage. Selecting an audit approach is discussed later in this lesson.

The Effect of Risks at the Financial Statement Level on the Relevant Assertion Level. The identification of risks at the financial statement level may also identify factors that increase the specific risks of material misstatement at the relevant assertion level for particular account balances, transaction classes, or disclosures. For example, if the auditor's overall risk assessment indicates a higher risk of senior management manipulating the financial statements, the auditor may identify significant accounting estimates as having a higher specific risk of material misstatement because of the general susceptibility of estimates to senior management bias. In that case, the auditor would identify specific risks related to the valuation assertion for account balances or transaction classes involving a relatively high degree of estimation uncertainty. The auditor would also identify those risks as fraud risks because they relate to fraudulent financial reporting. Similarly, if the auditor noted an overall risk from poor monitoring controls over the development of estimates and the use of judgments, the auditor may similarly identify specific risks related to the valuation assertion for significant accounts that involved a higher degree of judgment. However, in this case, the auditor may consider this a risk of potential misstatement due to error versus fraud.

The example in the previous paragraph illustrates how matters that represent risks at the financial statement level may also result in risks at the assertion level. Because of their nature, accounting estimates and related parties can both have that effect. As a result, AU-C 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and AU-C 550, *Related Parties*, require certain specific procedures to be performed as part of identifying and assessing the risks of material misstatement in accordance with AU-C 315B.

Special Considerations—Accounting Estimates. AU-C 540B.10–.11 indicates that as part of risk assessment, the auditor should evaluate the degree of estimation uncertainty of accounting estimates and determine whether any having a high degree of estimation uncertainty represents significant risks. The degree of estimation uncertainty associated with a particular accounting estimate may be influenced by a number of factors, as described in AU-C 540B.A45–.A46. Further, AU-C 540B.12 indicates that the auditor is required to determine, based on the risk assessment, whether (a) management has appropriately applied GAAP to the accounting estimate, (b) the method for making the estimate is appropriate and applied consistently, and (c) any change in the estimate or method from the prior period is appropriate.

Special Considerations—Related Parties. AU-C 550.20, as amended by SAS No. 135, states that the auditor should identify and assess the risks of material misstatement associated with related party relationships and transactions to determine whether they represent significant risks. It also requires that in making this determination, the auditor should treat identified related-party transactions that are significant unusual transactions as giving rise to significant risks. In addition, AU-C 550.21 indicates that if related party fraud risk factors are identified, the auditor should consider them in identifying and assessing fraud risks.

Special Considerations—Disclosures. SAS No. 134 amends the application guidance in AU-C 300, *Planning and Audit*, with additional discussion of risks factors to consider related to disclosures. Auditors need to consider disclosures when assessing risks and determining the audit response, which may affect the assessed risk of material misstatement. Auditors are encouraged to consider the following early in the audit planning process:

- Significant new or revised disclosures requirements due to changes in the entity's environment, financial condition, or activities.
- Significant new or revised disclosures requirements due to changes in the applicable financial reporting framework (GAAP).
- The potential need for an auditor's specialist to assist with auditing of disclosures.
- Disclosure-related matters the auditor may need to discuss with those charged with governance.
- Risks associated with information for disclosures from sources outside of the entity's general or subsidiary ledgers.

When assessing risks of material misstatement related to disclosures, the auditor considers both qualitative and quantitative information. The following are examples of qualitative information in disclosures that could be relevant when assessing risk of material misstatement:

- Terms and compliance with debt covenants and disclosers about liquidity, especially when in financial distress.
- Disclosure of events and circumstances that brought about recognition of an impairment loss.
- Discussion of estimation uncertainty for accounting estimates, including descriptions of assumptions used, such as those made about future events.
- Description of the nature of an accounting policy change.
- Description of the expected impact of a new or revised financial reporting requirement due to changes in the applicable financial reporting framework (GAAP).
- Disclosures about related-party relationships and transactions.
- Discussion of sensitivity analysis, such as changes in assumptions used in valuation techniques.

This list is not exhaustive, and the auditor needs to consider information gathered while obtaining an understanding of the entity specific to disclosure requirements applicable to the entity. This includes audits of smaller entities, even though the disclosures for such entities may be less detailed or complex.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. The following factors need to be considered in determining which audit areas are significant:

- Relative materiality of the account balances, transaction, or disclosures to the opinion unit financial statements.
- Relative significance of the transaction classes to the entity's operations or the overall opinion unit financial statements (for example, because of either the materiality of account balances affected or volume of transactions flowing through the accounts during the period).
- The susceptibility of the account balances, transaction classes, or disclosures to fraud, including both misappropriation of assets and intentional misstatement by management.
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.
- Disclosures that require additional effort at the account balance level in an audit area to ensure accuracy and completeness.

An audit area is a grouping of related account balances, transaction classes, and disclosures. For example, the accounts receivable and revenue audit area for a water and sewer fund includes revenue from customers, receivables from customers; collection of consideration from customers (cash receipts); the uncollectible-receivables allowance and expense accounts, and disclosures related to all those accounts. An audit area is a mixture of transactions, balances, and disclosures related to a particular area of an entity's operations. There are various ways of organizing an audit into areas. Some auditors use transaction cycles, such as the revenue cycle and expenditure cycle. Other auditors prefer to use financial position statement and related resource flows statement account balances, which is the approach used by PPC.

Major transaction class categories typically include revenues, purchases, cash receipts, and cash disbursements. Transaction classes are accumulated during the period covered by the resource flows statement in account balances. Thus, revenue, for example, is both an account balance and a transaction class and significance may be evaluated based on the account balance. Other transaction classes, such as cash receipts and cash disbursements, may affect many account balances, and significance is evaluated by the volume of the transactions during the period.

Describing Specific Risks of Material Misstatement. Within each audit area, the auditor describes the specific risks of material misstatement affecting the account balances, transaction classes, or related disclosures. The description includes the cause and direction of potential misstatement as well as the financial statement assertions affected. The auditor notes the cause of misstatement—error, fraudulent financial reporting, or theft—and the effect on direction of misstatement—overstatement or understatement.

As indicated in AU-C 315B.28–.31, the auditor's risk assessment should include an evaluation of whether the following risks are present:

- Significant risks that require special audit consideration.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

Those risks are discussed in the following two subsections.

<u>Significant Risks Requiring Special Audit Consideration.</u> AU-C 315B.28 indicates that, as part of his or her risk assessment, the auditor should determine whether any of the risks identified are significant risks. That determination excludes the effects of identified controls related to the risk. These risks are referred to as risks that require special

audit consideration. In other words, the auditor's determination of significant risk is based solely on the consideration of inherent risk. The AICPA Risk Assessment Audit Guide, paragraph 5.31, notes that in most audits, one or more significant risks normally arise. It observes with respect to the determination of significant risk that, in a situation in which the auditor assesses inherent risk as high, moderate, or low, a significant risk may be one that is higher than high and, thus, requires special audit consideration. Thus, a good rule of thumb is that every audit include at least one significant risk, and the response to significant risk needs to include modified or additional procedures beyond what would ordinarily be performed.

According to AU-C 315.29, as amended by SAS No. 135, the auditor should evaluate whether risks are significant risks by considering the following:

- Is the risk a risk of fraud?
- Is the risk related to recent significant economic, accounting, or other developments?
- Are the transactions complex?
- Does the risk involve significant transactions with related parties?
- Is there a relatively high degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant unusual transactions?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature. The observations and suggestions following paragraph 5.31 of the AICPA Risk Assessment Audit Guide suggest that it may be helpful to compare all high inherent risks to each other to assist with the identification of significant risks. In other words, by comparing all inherent risks to each other, an inherent risk that is higher than the ordinary high may be more apparent.

Examples of matters that often involve significant risks include the following:

- Significant unusual transactions.
- Accounting estimates for which there is high measurement uncertainty, such as landfill closure and postclosure care costs.
- Transactions that involve complex calculations or the application of complex accounting principles, such as accounting for defined benefit plans or accruing an arbitrage liability.
- Financial statement items for which management judgments (such as judgments about when it is appropriate to recognize revenue, management's intended future actions, or the likelihood of a future event) may affect recognition, classification, or disclosure.
- Significant related-party transactions.
- Transactions that require substantial manual intervention in data collection and processing.
- Unusual or infrequent transactions that by their nature make effective controls difficult to implement, such as major litigation.
- Transactions that involve a relatively large degree of management intervention in specifying the accounting treatment.

Every audit is likely to have at least one significant risk, but identifying too many risks as significant may be counterproductive. The AICPA Risk Assessment Audit Guide (in the observations and suggestions following paragraph 5.31) cautions that the unnecessary designation of too many risks as significant risks can impair the efficiency of the audit. Also, if the auditor plans to rely on the operating effectiveness of controls relating to a significant risk, the auditor cannot use evidence obtained in prior periods about the effectiveness of such controls.

Exhibit 2-5 provides a set of questions that were derived from the AICPA Risk Assessment Audit Guide that an auditor may use to determine whether a risk requires special audit consideration.

Exhibit 2-5

Questions to Consider When Determining Risks That Require Special Audit Consideration

- Which risks are most likely to require the immediate, focused attention of the auditor with the final responsibility for the audit? If an engagement quality control review is required, which risks would receive the initial or focused attention of the reviewer?
- Which risks are atypical for the client that could lead to material misstatement?
- Given previous experience with the client, which risks were unexpected?
- For which risks would the auditor be reluctant to apply only substantive analytical procedures?
- Hypothetically, if there was a constraint on available time to perform the audit, which risks are certain to be addressed through substantive tests of details?

The identification of risks of material misstatement as significant risks has important implications for further audit procedures, including tests of controls. Once the auditor has identified the risk as a significant risk, the auditor would ordinarily do the following:

- To the extent the auditor has not already done so, evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented (required by AU-C 315B.30).
- Determine whether the audit approach will involve reliance on controls.
- If the auditor plans to rely on the operating effectiveness of controls intended to mitigate the significant risk, perform tests of controls in the current period. Reliance on evidence from tests of controls performed in prior periods is not permitted.
- Perform substantive procedures that are specifically responsive to the risk.
- If the auditor does not plan to rely on controls and is performing only substantive procedures, the substantive procedures need to be tests of details only or a combination of tests of details and substantive analytical procedures. (AU-C 330B.22 notes that when there are significant risks at the relevant assertion level, substantive procedures should include tests of details when the response consists of only substantive procedures.)
- Document the significant risks identified and related controls evaluated (required by AU-C 315B.33).

In determining the appropriate audit response to significant risks, the auditor considers his or her understanding of the relevant controls, including control activities. The most effective audit approach may depend on whether management has identified the risk and responded by designing and implementing effective controls.

Because risks designated as significant risks are risks that require special audit consideration, the auditor needs to evaluate whether the risk is pervasive for the assertion or more limited. A significant risk may relate to a particular aspect of an assertion that can be addressed separately. With respect to the existence of capital assets, for example, the capitalization of software costs or the capitalization of costs of self-constructed assets may be significant risks, but other aspects of the existence assertion may pose only normal risks. Another example is the existence assertion or valuation assertion for investments. Derivative investments may pose significant risks, but other investments may not. The auditor needs to avoid unnecessarily identifying all aspects of an assertion for an account balance, transaction class, or disclosure as a significant risk when that designation applies only to a particular aspect of the assertion that can be addressed separately.

Risks for Which Substantive Procedures Alone Are Not Sufficient. As part of the auditor's risk assessment, the auditor might identify risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures; that is, substantive procedures alone will not be sufficient. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, situations in which a significant amount of the entity's information is initiated, authorized, recorded, processed, or reported electronically.

Assessing Inherent Risk. Inherent risk is the susceptibility of a relevant assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. If control risk is assessed as high, the inherent risk assessment is the only variable that determines the risk of material misstatement, and significantly affects the auditor's planned further audit procedures.

Inherent risk is higher for some assertions related to an account balance, class of transactions, or disclosure than for others. Considering inherent risk factors involves contemplation of the influence of the environment and the nature of the items comprising an account balance, transaction class, or disclosure on the possible occurrence of material misstatements, whether caused by error or fraud, in the financial statements. Unlike the control risk assessment, which requires tests of controls for assessment of risk below a high level, inherent risk assessment is an intuitive process based on the auditor's knowledge of the client and related audit area. For example, an auditor of a governmental unit that has material financial statement balances in investments and capital assets might assess inherent risk higher for assertions related to investments than for assertions related to capital assets. Even if both of the accounts have material financial statement balances and are considered significant audit areas, the investments account has a high level of activity throughout the year and is typically significant to financial statement users of a governmental unit. In contrast, the balance in the capital asset account is made up primarily of transactions that occurred and were audited in prior years.

Because the inherent risk assessment is made before consideration of related controls, factors such as the following may be considered by the auditor:

- *Engagement Risk.* The effect of risk factors at the opinion unit or engagement level.
- *Accounting Issues.* The complexity and contentiousness of accounting issues.
- *Auditing Issues.* The frequency or significance of difficult-to-audit transactions or disclosures.
- *Prior Period Misstatements.* The nature, cause, and materiality of misstatements detected in prior audits.
- *Susceptibility to Fraud.* The susceptibility to fraud, including both misappropriation of assets and fraudulent financial reporting.
- *Need for Judgment.* The extent of judgment involved. For example, accounting estimates require more judgment than account balances that represent a total of exchange transactions.
- *Nature of Items.* The size and volume of items comprising the account balances or transaction classes and the quantitative and qualitative aspects of information disclosures.
- *Complexity.* The complexity of calculations.

SLG, Paragraph 4.138, Appendix A-11, provides the following examples of accounts, classes of transactions, and assertions that have a high inherent risk because they involve a high degree of management judgment and subjectivity and may also present risks of material misstatement due to fraud because they are susceptible to manipulation by management:

- Valuation of investments for which quoted market price is unavailable, receivable allowances, and excessive or obsolete supplies inventory.
- Interfund receivables/payables that are long-outstanding and may not represent valid rights and obligations.
- Valuation of the recourse liability for receivables sold with recourse.

- Valuation of liabilities for compensated absences, claims and judgments (including risk financing liabilities), termination benefits, pension benefits, postemployment benefits other than pensions (OPEB), pollution remediation liabilities, and landfill closure and postclosure care costs.
- Restrictions on net position.
- Classification of revenues as program versus general.
- Classification of interfund and internal activity and balances, including elimination of allocated expenses.
- Depreciation of capital assets, where applicable, especially those with long useful lives.
- Classification of capital assets as land versus land improvements versus infrastructure assets, which affects classification and allocation of costs.
- Status of specific conditions that could affect the classification of internally generated intangible assets such as capital assets versus expenses.

Another consideration is asset retirement obligations in accordance with GASBS No. 83.

Assessing Inherent Risk of Related Account Balances. An issue that sometimes arises in practice is whether an assessment of inherent risk for one account balance within an audit area should apply to all the other accounts within the same audit area. For example, if inherent risk is high for the existence/occurrence assertion for revenue, should it also be high for accounts receivable? There are several considerations that could cause the inherent risks of material misstatement to be different for account balance assertions within the same audit area. Auditors need to consider factors such as the following:

- What are the inherent risks by assertion for each account balance within an audit area? (For example, the inherent risk of a material misstatement for cutoff is not necessarily the same as for other assertions.)
- Is there something about the governmental unit's operations or policies and procedures that changes the normal relationship among account balances in an audit area and, as a result, changes the inherent risk for the relevant assertion? (For example, a practice of collecting payment in advance of performing the service may change the normal expected relationship for the existence/occurrence assertion between revenue and receivables.)
- If account balances are affected by different transaction streams, does the inherent risk for a particular assertion differ among the transaction streams?

The factors listed above are examples of how a careful consideration of the factors affecting inherent risk by assertion may result in the inherent risk assessment being different for account balances within the same audit area. Auditors need to consider specific risks by assertion rather than apply a blanket risk assessment to an audit area.

Documenting the Inherent Risk Assessment. It is a best practice for the auditor to document the inherent risk assessment. One option for doing so is by using the practice aids provided in *PPC's Guide to Audits of Local Governments*. Inherent risk assessment is an intuitive process based on the auditor's knowledge of the client and related audit area. The auditor's understanding of the entity, identification of risks, performance of other risk assessment procedures, and consideration of the factors listed earlier generally provide a basis to assess inherent risk. If the auditor chooses, the basis for the inherent risk assessment can be documented in more detail by (a) identifying factors that significantly affect inherent risk and (b) indicating how those factors affect the auditor's assessment. An auditor can make an overall, or combined, assessment of the risk of material misstatement at the assertion level. Alternatively, the auditor can make separate assessments of inherent risk and control risk and then combine them.

Assessing Control Risk. The next step is a qualitative evaluation of control risk as high, moderate, or low at the assertion level. Though outside the scope of this course, *PPC's Guide to Audits of Local Governments* provides a detailed discussion of testing internal controls and assessing control risk.

<u>Documenting the Control Risk Assessment.</u> If tests of the operating effectiveness of controls are performed to support a reduced assessed level of control risk, the auditor may choose to document them. A list of controls by transaction class within each audit area (such as the one provided in the related practice aids in *PPC's Guide to Audits of Local Governments*) can be used to gain a further understanding of the design and implementation of controls and to indicate the controls, if any, the auditor plans to test.

Based on the evaluation of mitigating controls and consideration of the results of procedures performed to support the control risk assessment, the auditor then evaluates control risk and documents it in the qualitative categories of high, moderate, or low. The auditor's assessment of control risk as high, moderate, or low ought to be supported by the procedures performed. If this is done before planned tests of controls are actually performed, the documented control risk assessment is the preliminary assessed level of control risk that the auditor plans to support by performing the control tests. If the results of the tests of controls do not support that planned assessment, the auditor needs to revise the assessment and reconsider the effect on the audit approach.

Need for Improvement in Assessing Control Risk. The AICPA Risk Resources analysis of peer review Matters for Further Consideration (MFC) found that 40% of identified issues resulted from a failure to obtain an understanding of internal control when identifying risks. AU-C 315B.14 specifically requires the auditor, when obtaining an understanding of controls relevant to the audit, to evaluate the design of those controls and to determine whether they have been implemented by performing procedures in addition to inquiry. An auditor cannot default to a high control risk. An auditor's preliminary assessment of control risk related to a relevant assertion has to be based on an evaluation of the design and implementation of controls related to that assertion.

Substantive procedures have to be responsive to the assessed risks of material misstatement at the relevant assertion level. If an auditor assesses control risk as high for a relevant assertion without obtaining an understanding of the design and implementation of controls related to that assertion, the substantive procedures applied may not be responsive to what can go wrong at the relevant assertion level. In such circumstances, the likelihood of underauditing or overauditing increases.

The AICPA Risk Resources analysis also found that in 13% of the issues identified, control risk was assessed as less than high without applying tests of controls. AU-C 315B.27c indicates the auditor should relate identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test. An auditor may identify individual, or a combination of, control activities that are likely to prevent, or detect and correct, material misstatement in specific assertions AU-C 330B.08 indicates that the auditor should design and perform tests of controls to obtain sufficient appropriate evidence of their operating effectiveness when the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation of such effectiveness. In other words, if an auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures, the results of tests of controls of operating effectiveness have to support the assessment of control risk as less than high.

Assessing the Combined Risk of Material Misstatement. RMM, the product of IR and CR, is the auditor's combined assessment of the two risks. The auditor is permitted to make an overall, or combined, assessment of the risk of material misstatement at the assertion level. Alternatively, the auditor can make separate assessments of inherent risk and control risk and then combine them. The auditor evaluates the remaining specific risk of material misstatement (combination of inherent risk and control risk) as high, moderate, or low. The authors have developed the table in Exhibit 2-6 to assist auditors in determining the combined assessed risk of material misstatement when the auditor makes separate assessments of inherent risk and control risk. A nonauthoritative Technical Question and Answer (Q&A 8200.09), *Assessing Inherent Risk*, notes that control risk is always considered in the assessment of the combined risk of material misstatement even if inherent risk is assessed as low.

Exhibit 2-6

Combining Inherent Risk and Control Risk

Inherent Risk (IR)	×	Control Risk (CR)[a]	=	Risk of Material Misstatement (RMM)[b]
High		High		High
High		Moderate		High
High		Low		Moderate to High
Moderate		High		Moderate to High
Moderate		Moderate		Low to Moderate
Moderate		Low		Low to Moderate
Low		High		Moderate to High
Low		Moderate		Low to Moderate
Low		Low		Low

Notes:

[a] An assessment of CR lower than high requires identification of controls that would prevent or detect and correct material misstatements at the relevant assertion level and obtaining sufficient audit evidence of the effective operation of those controls.

[b] The level of RMM indicated in this table for corresponding levels of assessed IR and CR is the typical level of RMM for the indicated combination and should be used as a guideline rather than a mathematical determination. The assessed level of RMM is subject to professional judgment, and an auditor's judgment in the particular circumstances may indicate a different RMM is appropriate. In those circumstances, the authors believe this could be appropriate so long as each assessment is supportable and appropriately documented.

Several of the combinations of inherent risk and control risk (the component risks) in the table in Exhibit 2-6 are presented as a range of nonquantitative risk levels rather than a single level of risk of material misstatement. The reason is that the risk model was not intended to be and does not function as a strict mathematical formula. The following factors support use of ranges of risks of material misstatement for various combinations of inherent risk and control risk:

- The implicit constraint of auditing standards that establishes a floor for component risk assessments.
- Variations in the quality of evidence available to support the assessment of component risks.
- The differences between use of a nonquantitative approach rather than a quantified percentage of risk.
- The subjective and judgmental nature of assessment of risks of material misstatement.

First, auditing standards impose an implicit constraint on assessment of component risks. AU-C 330B.18 requires the auditor to design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure irrespective of the assessed risks of material misstatement. The practical effect of this requirement has generally been viewed as meaning that the assessment of the component risks of inherent risk and control risk cannot be so low that the resulting combined risk of material misstatement indicates no substantive procedures are necessary. This requirement may also be viewed as a safeguard against overreliance on the results of a subjective risk assessment to the detriment of obtaining more objective and verifiable evidence from substantive procedures. Thus, the combination of component risks may be a higher level of risk of material misstatement than would result from a strictly mathematical approach.

Second, a range for the combined result allows an auditor to recognize variations in the quality of evidence available to support assessment of a component risk. For example, a range of moderate to high for the combined risk allows an auditor to select a high risk of material misstatement when the inherent risk is based only on inquiry and observation for a new client for which an auditor has limited experience. Conversely, an auditor may select a moderate risk of material misstatement when the inherent risk assessment is based on higher quality evidence. Also, a control risk assessment below high is generally the result of considering a higher quality of evidence because the assessment is based on tests of controls such as inspection of documents and reperformance in addition to inquiry and observation.

Third, presenting the combination of the component risks as a range of nonquantitative levels of risk rather than as a single level recognizes an inherent characteristic of the nonquantitative approach to risk assessment. A quantitative assessment of risk would result in a single percentage of risk. For example, if inherent risk is 60%, and control risk is 50%, the resulting risk of material misstatement is 30% ($.6 \times .5 = .30$). The specific percentages are still the result of professional judgment and not precise calculations, but the combination is a single quantified level of risk. Using a nonquantitative approach injects an additional consideration that a nonquantitative level of risk in effect represents a band or range of quantitative levels. For example, an auditor may regard inherent risk assessments of 70% or 100% as both being high. The authors believe that presenting the risk of material misstatement as a range better reflects the range of possible results of combining component risks that themselves encompass a range of quantitative assessments. Using a range allows an auditor to select a nonquantitative level of risk of material misstatement that better reflects the auditor's judgment about the degree of risk. For example, is a judgment of a component risk as high at the maximum (equivalent to 100%) or is the risk high, but closer to moderate than maximum?

Finally, determining the risk of material misstatement is a subjective professional judgment. Auditing standards require the auditor to identify risks and then assess whether those identified risks represent risks of material misstatement at the relevant assertion level. Auditing standards do not require a separate assessment of the component risks of inherent risk and control risk. Thus, the separate assessments and use of a practice aid such as the table in Exhibit 2-6 should be viewed only as a tool to achieve a more efficient and effective design of the nature, timing, and extent of further procedures that is responsive to the assessed risk at the assertion level. An auditor's assessment of the risk of material misstatement may differ from the RMM level in the table in Exhibit 2-6 and be changed judgmentally to better fit the circumstances, but the authors believe this could be appropriate so long as each assessment is supportable and appropriately documented.

Documenting the Risks of Material Misstatement. AU-C 315B.33 requires the auditor to document the assessment of the risk of material misstatement at the relevant assertion level. (Auditors also are required to document any fraud risks or other significant risks they identify.) If desired, the auditor can comply with these documentation requirements by (a) identifying significant audit areas; (b) identifying fraud risks and other significant risks; (c) documenting the auditor's assessment of inherent risk, control risk, and combined risk of material misstatement at the assertion level; and (d) describing the auditor's planned response (i.e., audit approach) on the practice aids provided in *PPC's Guide to Audits of Local Governments*.

Responding to the Risk Assessment. The purpose of the risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. For simplicity in the discussions throughout this course, the authors have referred to the overall decision of which further audit procedures will be performed as the selection of an audit "approach." Determining the audit approach and designing a detailed audit plan that takes into account the auditor's planned response to the risk assessments are discussed later in this lesson. Linking the planned response to the risk assessment is essential; linkage is also discussed in more detail later in this lesson.

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 assertions relates to account balances instead of transaction classes?

    a. Existence.

    b. Occurrence.

    c. Cutoff.

    d. Completeness.

11. Which of the following statements best describes an auditor's synthesis of information relevant to the identification of potential risks?

    a. It is a mental process based on the auditor's professional judgment.

    b. It is done after the auditor has developed responses to identified risks.

    c. There is a one-to-one relationship between the information gathered and risks noted.

    d. The main consideration of the auditor during synthesis is pervasiveness of risks.

12. Which of the following steps will help an auditor using the PPC audit approach to assess the risks of misstatement at the relevant assertion level?

    a. Identify risks of material misstatement to the financial statements as a whole.

    b. Rank audit areas in relation to significance.

    c. Makes a quantitative assessment of inherent risk as a dollar amount or range.

    d. Evaluate the nature and level of specific risks at the relevant assertion level.

13. Luke is engaged to audit a governmental unit. He assesses inherent risk as high and control risk as low. At what level should Luke assess risk of material misstatement?

    a. High.

    b. Moderate to high.

    c. Low to moderate.

    d. Low.

SELF-STUDY ANSWERS

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

10. Which of the following assertions relates to account balances instead of transaction classes? **(Page 213)**

    a. **Existence. [This answer is correct. Assertions about account balances and related disclosures at the end of the period include the existence assertion. This is an assertion that assets, deferred outflows of resources, liabilities, and deferred inflows of resources exist.]**

    b. Occurrence. [This answer is incorrect. The occurrence assertion is associated with transactions, not account balances. It asserts that transactions and events that have been recorded or disclosed have occurred and such transactions and events pertain to the entity.]

    c. Cutoff. [This answer is incorrect. The cutoff assertion (that transactions and events have been recorded in the correct accounting period) is associated with transactions, not account balances.]

    d. Completeness. [This answer is incorrect. Typically, there is a completeness assertion related to both transaction classes and account balances.]

11. Which of the following statements best describes an auditor's synthesis of information relevant to the identification of potential risks? **(Page 218)**

    a. **It is a mental process based on the auditor's professional judgment. [This answer is correct. Once auditors have accumulated information relevant to the identification of potential risks, the information is evaluated together. Auditors apply professional judgment to determine whether the information gathered during the risk assessment process, either individually or in the aggregate, indicates areas where the entity's financial statements might be susceptible to material misstatement (whether due to error or fraud). This is referred to as *synthesis*. Synthesis is a mental process involving analysis of the information gathered to identify risks.]**

    b. It is done after the auditor has developed responses to identified risks. [This answer is incorrect. Only *after* the auditor can clearly articulate the risks (which occurs during synthesis), can he or she ordinarily assess the risks and develop appropriate responses.]

    c. There is a one-to-one relationship between the information gathered and risks noted. [This answer is incorrect. There may *not* be a one-to-one relationship between the pieces of information gathered and risks of material misstatement of the financial statements but combining seemingly unrelated information indicates a risk. The totality of the information gathered, when synthesized, could actually lead to the identification of an overall risk at the financial statement level, such as a lack of personnel with appropriate accounting and financial reporting skills.]

    d. The main consideration of the auditor during synthesis is pervasiveness of risks. [This answer is incorrect. To synthesize the information and identify risks, auditors consider the information in the context of a variety of items, including the broad type of risk and the pervasiveness of the risk, among others. They do not focus all of their attention on pervasiveness.]

12. Which of the following steps will help an auditor using the PPC audit approach to assess the risks of misstatement at the relevant assertion level? **(Page 227)**

    a. Identify risks of material misstatement to the financial statements as a whole. [This answer is incorrect. While auditors may need to do this at some point, when assessing the risks of material misstatement at the relevant assertion level, they should identify any documented risks of material misstatement at the opinion unit financial statement level that affect the risks of material misstatement for particular account balances, transaction classes, or disclosures. This identification is at a lower level than the financial statements as a whole.]

b. Rank audit areas in relation to significance. [This answer is incorrect. When using the PPC audit approach for this assessment, auditors should determine those audit areas that are significant. This would involve pulling out the significant areas, not ranking all the areas from greatest to least significance.]

c. Makes a quantitative assessment of inherent risk as a dollar amount or range. [This answer is incorrect. According to the PPC audit approach, the auditor should make a qualitative assessment of both inherent and control risk as high, moderate, or low for each relevant assertion.]

d. **Evaluate the nature and level of specific risks at the relevant assertion level. [This answer is correct. PPC's Audit approach includes certain steps that will help auditors assess the risks of material misstatement at the relevant assertion area. One of those steps is to determine the specific risks of material misstatement by relevant assertion for each account balance, transaction class, or disclosure within each significant audit area and evaluate the nature and level of the specific risks.]**

13. Luke is engaged to audit a governmental unit. He assesses inherent risk as high and control risk as low. At what level should Luke assess risk of material misstatement? **(Page 234)**

a. High. [This answer is incorrect. An assessment of risk of material misstatement as high would be appropriate if Luke assessed both inherent and control risk at high, or if he assessed inherent risk as high and control risk as moderate.]

b. **Moderate to high. [This answer is correct. When inherent risk is high and control risk is low, Luke should assess the risk of material misstatement for his engagement as moderate to high. This would also be the case if inherent risk was moderate and control risk was high and if inherent risk was low and control risk was high.]**

c. Low to moderate. [This answer is incorrect. Luke would assess the risk of material misstatement at low to moderate if inherent risk and control risk are both moderate, if inherent risk is moderate and control risk is low, or if inherent risk is low and control risk is moderate.]

d. Low. [This answer is incorrect. Luke should only assess the risk of material misstatement as low if both inherent risk *and* control risk are assessed as low.]

THE CONSIDERATION OF FRAUD RISKS

The auditor's consideration of fraud risk under the requirements of AU-C 240B is not separate from consideration of audit risk; rather, it is integrated into the overall audit risk assessment process described both in this course and in *PPC's Guide to Audits of Local Governments*. For instance, identification of fraud risks is a natural by-product of performing the risk assessment and other planning procedures. Furthermore, as described in this lesson, the auditor's assessment of the risks of material misstatement encompasses misstatements caused by both error and fraud.

Although the requirements and guidance presented in the auditing standards may seem to 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. Risk assessment procedures are performed concurrently with other procedures, and the evaluation of risks, including fraud risks, occurs continuously throughout the audit. This course integrates the requirements of AU-C 240B within the overall risk assessment process by addressing those requirements at relevant points. This section discusses in more detail how the auditor considers fraud risks. Identified fraud risks may call for an overall response, one that is specific to a particular account balance, class of transaction, or disclosure at the relevant assertion level, or both. An overall response generally is considered when establishing the overall audit strategy. A specific response is considered when developing the detailed audit plan.

Specialized Considerations for Governmental Units

AU-C 240B.A8 notes that the auditor of governmental entities may have additional responsibilities relating to fraud as a result of being engaged to conduct an audit in accordance with law or regulation applicable to governmental entities because of a governmental audit organization's mandate or because of the need to comply with *Government Auditing Standards*. Therefore, the responsibilities of the auditor of governmental entities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Fraud Risk Factors

When obtaining an understanding of the entity and its environment, including its internal control, AU-C 240B requires auditors to consider whether fraud risk factors are present. Fraud risk factors are events or conditions that indicate the presence of incentives or pressures to commit fraud, opportunities to carry out the fraud, or attitudes/ rationalizations to justify the fraud.

The examples of risk factors presented in AU-C 240B.A76 (Appendix A) are 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 standard further classifies the illustrative risk factors into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. The auditor recognizes the possibility of other risk factors not specifically listed in the standard. In fact, AU-C 240B.A76 (Appendix A) specifically points out that the examples may not be all inclusive, may not apply in all instances, or may be more or less significant depending on the nature, size, or ownership characteristics of the entity.

The auditor's primary concern when considering fraud risk factors is to identify whether a risk factor is present and ought 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 whether it ought to be considered in identifying and assessing the risks of material misstatement due to fraud is a matter of the auditor's exercise of professional due care and professional skepticism. When evaluating whether a fraud risk factor is present, the auditor does not consider significance or mitigating controls. Those matters are considered later in this lesson.

Identifying Risks of Material Misstatement Due to Fraud

Under AU-C 240B, the risk assessment and other planning procedures the auditor performs in accordance with AU-C 315B.26 assist the auditor in identifying the risks of material misstatement, whether due to error or fraud. According to AU-C 240B.25, the auditor should identify and assess the risks of material misstatement due to fraud at the assertion level for classes of transactions, account balances, and disclosures. The auditor gathers information from a number of sources to identify risks that may result in material misstatement of the financial statements due to fraud. The auditor combines, or synthesizes, all of the information gathered to identify areas in which the opinion unit financial statements are susceptible to material misstatement due to fraud. The auditor then articulates those risks in terms of their potential effects on the financial statements.

Considering Fraud Conditions. When identifying fraud risks, it may be helpful to consider the information gathered in the context of the three conditions generally present when fraud occurs: incentives/pressures, opportunities, and attitudes/rationalizations. The nature of the observed fraud conditions may assist the auditor in determining the type of risk. For example, information related to personal financial obligations or dissatisfaction of employees, assets susceptible to theft, and inadequate safeguarding controls generally indicates susceptibility to misappropriation of assets. Information related to external pressures to present favorable financial condition or operating results, accounts or transactions susceptible to manipulation, and inadequate monitoring and financial reporting controls generally indicates susceptibility to fraudulent financial reporting.

Fraud conditions may relate to observed attitudes or rationalizations. For example, the auditor may have observed changes in behavior or lifestyle that indicate increased risk that misappropriation might be occurring. Similarly, the auditor may have observed management exhibiting an excessive interest in the selection and application of accounting policies, or use of the concept of materiality to justify inappropriate accounting. These conditions provide an indication of increased risk that management may be manipulating the financial statements.

Accumulated information may indicate only one fraud condition, two, or all three (incentives/pressures, opportunities, and attitudes/rationalizations). However, the auditor does *not* assume it is necessary to observe all three conditions before concluding there are fraud risks. Although the risk of material misstatement due to fraud may be greatest when all three conditions exist, the auditor may not be able to observe the presence of all of these conditions. Some of these conditions, such as attitude, are difficult to observe but may, nonetheless, be present. In addition, even if all of the conditions are not observed, fraud can still occur. In some cases, the extent of one condition may be so significant that fraud risks exist, even though the other conditions are not significant. For example, a significant incentive to commit fraud, such as to prevent a debt default, may alone be sufficient to constitute a risk of material misstatement due to fraud. Similarly, an easy opportunity to commit fraud, such as poor asset safeguarding, may alone be sufficient to constitute a fraud risk. The consideration of observed fraud conditions requires the auditor to exercise professional skepticism and additional scrutiny of audit areas implicated by the fraud risk, as illustrated in the following example.

Example 2-3: Identifying a fraud risk.

The Township of Montville has a declining property and earned income tax base and has recently been subjected to significant unfunded mandates by the state government. Management of the township is dominated by a new professional manager and oversight of him is weak because township supervisors are all inexperienced and have little time to devote to supervision. The township's financial statements include subjective and material estimates, including valuation of liabilities for compensated absences, claims and judgments, and landfill closure and postclosure care costs. Thus sufficient fraud risk factors exist to identify a risk of fraudulent financial reporting. If the incentive and opportunities for fraud were not present, the auditor might conclude that the mere existence of subjective accounting estimates results in a risk of error, but not fraud.

The Synthesis Process. The auditor is responsible for obtaining reasonable assurance of detecting fraud that could result in material misstatement of the opinion unit financial statements. As part of the synthesis process, the auditor assesses the identified fraud risks to consider whether potential misstatements could result in material misstatement of the opinion unit financial statements. Synthesizing the information was discussed in more detail earlier in this lesson.

Articulating Fraud Risks. As previously discussed, the authors encourage the auditor to be as specific as possible when describing risks of material misstatement due to fraud. Where possible, it is helpful to identify the account balance, class of transactions, or disclosures and specific relevant assertions affected and how they may be affected (that is, overstatement or understatement). Risks of material misstatement, including risks due to fraud, may be articulated in a way that is meaningful for use in assessing risks and determining further audit procedures to be performed.

Presumption of Revenue Recognition as a Fraud Risk. Material misstatement of the financial statements due to fraudulent financial reporting often results from improper revenue recognition. Revenue may be overstated, by recognizing revenue before the performance obligation is satisfied, or understated, by shifting revenue to a later period. However, even revenue that is recorded in the proper period may be misstated in a governmental unit by intentionally recording it in the wrong fund. AU-C 240B.26 requires auditors to ordinarily presume that improper revenue recognition is a risk of material misstatement of the financial statements due to fraud and to evaluate which types of revenue, revenue transactions, or assertions are affected by the risks. Consider which types of revenue, revenue transactions, and assertions give rise to the risk of improper revenue recognition due to fraud. Risks of material misstatement due to fraud are always significant risks. The Observations and Suggestions at paragraph 5.31 of the AICPA Risk Assessment Audit Guide state that significant risks are those with inherent risk that is "higher than the usual high," thus requiring special attention in the audit. The authors believe that the presence of fraud risk qualifies revenue as a significant audit area, as described earlier in this lesson.

Some auditors have indicated that the risk of improper revenue recognition by a governmental entity is almost nonexistent because of the nature of a government's revenues. However, auditors should presume that the risk exists. In a small government, management might intentionally misstate revenue by:

- Recognizing significant revenues on a cash basis instead of accrual or modified accrual basis.
- Recording revenue in the wrong fund.
- Understating or overstating the allowance for uncollectible receivables.
- Failing to net revenue against expenses/expenditures when required, for example, when insurance recoveries are received in the same year as an impairment loss.
- Recognizing revenue from a legal judgment before the amount is realizable.
- Recognizing revenue from cost reimbursement grants for costs that were not incurred.

The presumption that improper revenue recognition as a fraud risk is rebuttable, and the accompanying designation of revenue as a significant risk, may be overcome. The authors believe affirmative reasoning and an evaluation of observed fraud conditions, rather than negative reasoning (such as "nothing came to our attention") are needed to overcome the presumption. Affirmative reasons may include an absence of significant pressures or incentives and an absence of realistic opportunities. However, the auditor needs to consider whether a specific opinion unit might have revenue recognition as a fraud risk. If the auditor lacks an affirmative reason to overcome the presumption that revenue recognition is a fraud risk, or if the auditor has observed the presence of fraud conditions related to improper revenue recognition, he or she evaluates that information with a heightened awareness of the need to identify improper revenue recognition as a fraud risk. Because revenue is generally material to the financial statements, if there are one or more indications of potential improper revenue recognition gathered during the risk assessment process, the authors believe the auditor ordinarily will not be able to overcome the presumption. If improper revenue recognition is not identified as a risk of material misstatement of the financial statements due to fraud, the auditor is required by AU-C 240B.46 to document the reasons supporting that conclusion. Documenting fraud risks is discussed in more detail later in this section.

Information that suggests a potential risk of improper revenue recognition may, at first glance, not seem directly related to revenue. For example, the existence of debt covenants that are difficult to maintain may not initially prompt an auditor to consider the risk of improper revenue recognition. The auditor may need to dig deeper to identify the specific risk associated with a particular risk factor. However, any information that suggests an incentive or pressure to overstate or understate a governmental unit's financial results causes the auditor to consider appropriate response to the risk of improper revenue recognition. In addition, absent an effective oversight process, the opportunity for improper revenue recognition almost always exists because of the possibility that management can override controls.

Consideration of Revenue Related Fraud Risk at the Assertion Level. When considering risk factors and their implications for the audit, consideration of the effects at the assertion level is important. Additional work may be required in certain areas to reduce audit risk to an acceptable level. The following are examples of revenue risks by assertion that may require special focus when planning the audit:

- *Existence or Occurrence.* Significant pressure to meet budgeted revenues and avoid a deficit may give management an incentive to overstate revenue in the current period. (Many auditors believe the greater risk in a governmental environment is misstatement of expenditures. SLG, Paragraph 4.138, Appendix A-8, footnote 6, indicates that this belief does not preclude the requirement in AU-C 240B to presume a risk of material misstatement due to fraud as it relates to revenue. If the auditor does not identify improper revenue recognition as a risk, the auditor must document the reasons supporting this conclusion.)
- *Completeness.* Surplus revenue in the current period may lead management to understate current revenue to shift budgeted funds to the next period.
- *Rights or Obligations.* Failure to identify or comply with availability and eligibility criteria may result in improper deferral or acceleration of revenue recognition.
- *Valuation or Allocation.* Valuation of receivable allowances may require judgment and be subject to management bias, resulting in misstated revenue.
- *Accuracy or Classification.* Revenue may not be presented in the financial statements in accordance with GAAP (or other special purpose framework) or entity policy, including classification of revenues as program versus general. Disclosures may not be presented in the financial statements in accordance with GAAP.
- *Cutoff.* Several of the risk factors noted above could also result in revenue being recognized in the incorrect period.

In addition, risk may vary for different areas of the governmental unit's operations and opinion units. For example, inherent risk for existence or occurrence may be assessed as high due to presumed fraud risk for only one revenue source due to present fraud risk factors, such as a new program or grant. The auditor would document this rationale for the risk assessment and plan additional audit procedures specifically for the portion of the entity's accounts and transactions affected by the fraud risk factors.

AU-C 330B.22 notes that when there are significant risks at the relevant assertion level, substantive procedures should include tests of details when the response consists of only substantive procedures (i.e., no reliance is being placed on internal control). Substantive analytical procedures may also be applied; however, analytical procedures alone would not be sufficient to address the assessed risk(s) of material misstatement due to fraud. When using the PPC approach, the auditor would include basic and relevant extended procedures when designing the audit program for those assertions with assessed risks of material misstatement due to fraud.

Disclosure-related Fraud Risk. SAS No. 134 amends the auditing standards to help ensure auditors give appropriate attention to disclosures, and address risks of material misstatement related to disclosures in the same manner as such risks are addressed for classes of transactions, events, and account balances. AU-C 240.15, as amended by SAS No. 134, requires that the discussion among the engagement team about how and where the financial statements may be susceptible to material misstatement due to fraud include individual statements and disclosures. AU-C 240.A13, as amended, indicates the discussion may include consideration of the risks of attempts to obscure a proper understanding of information disclosed, such as by using unclear or ambiguous language. AU-C 240.A6, as amended, notes that management may override controls to intentionally omit, obscure, or misstate required disclosures or other disclosures necessary to achieve fair presentation.

Fraud Risks Related to Significant Unusual Transactions. AU-C 240.A76, as amended by SAS No. 135, indicates that the following situations related to significant unusual transactions are fraud risk factors that may be opportunities for fraudulent financial reporting:

- Related-party transactions that are also significant unusual transactions.
- Significant transactions with related parties whose financial statements are not audited or audited by another firm.
- Significant or highly complex transactions, or significant unusual transactions, especially those close to period end, that pose difficult "substance over form" questions.
- Contractual arrangements that lack a business purpose.

AU-C 240B.32c indicates that a significant unusual transaction that lacks business purpose suggests the transaction may have been entered to engage in fraudulent financial reporting or misappropriate assets. AU-C 240B.A54 provides a list of indicators that suggest significant unusual transactions may have been entered to engage in fraud, including transactions that lack commercial or economic substance. Auditors need to remain alert for the fraud risks indicated by significant unusual transactions and design and perform an appropriate response that considers the business purpose and economic substance of those transactions.

Considering Mitigating Controls. AU-C 240B requires the auditor to assess identified fraud risks, taking into account an evaluation of the entity's antifraud programs and internal controls. Before developing a response to identified fraud risks, the auditor evaluates whether the risks are mitigated by internal controls and other antifraud programs that address those risks. In determining whether an identified fraud risk is mitigated, the auditor considers the risk assessment and other procedures performed to obtain an understanding of the entity and its environment, including its internal control.

The auditor considers whether the entity's antifraud programs and internal controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies may exacerbate the risks. Because assessed risks of material of misstatement due to fraud are considered to be significant risks, AU-C 240B.27 requires the auditor to understand and evaluate controls, including control activities, relevant to such risks. As part of the risk assessment and other procedures performed to obtain an understanding of the entity and its environment, the auditor evaluates whether the entity's antifraud programs and internal controls that address identified fraud risks have been properly designed and implemented, and whether those programs and controls mitigate the identified fraud risks. Control deficiencies may exacerbate the risks. Given that the risk of improper revenue recognition is presumed to exist, the AICPA Risk Assessment Audit Guide notes at paragraph 3.102 that controls relating to revenue recognition are usually relevant to the audit.

For many governmental units, a major mitigating factor may be the oversight provided by the governing body. Generally, there is no motivation for the governing body of a governmental unit to materially misstate the financial statements. Therefore, active governing bodies can be strong mitigating factors. The auditor ought to regularly reassess the body's effectiveness as a mitigating factor, however, since the governing bodies of many governmental units turn over regularly. Additionally, in many governmental units, another mitigating factor might be management's efforts to monitor actual-to-budget revenues and expenditures, which can reduce the risk of improperly classified amounts.

Does the auditor need to perform tests of controls to determine whether antifraud programs and controls mitigate identified fraud risks? Clearly, the auditor cannot conclude that a risk is mitigated by a control without first gaining comfort that the control actually has been appropriately designed and placed in operation. Determining whether it is necessary to test the operating effectiveness of the control, however, needs to be based on a careful consideration of the implications of the assessed level of risk. Ordinarily, the auditor tests controls only if it is efficient (that is, if the time and cost saved by reducing substantive procedures exceeds the time and cost of testing controls) or if detection risk cannot be reduced to an acceptable level without testing controls. If the auditor decides to test controls, knowledge gained while performing risk assessment and other procedures to obtain an understanding of the entity and its environment may provide evidence that a control is operating effectively. In other cases, however, detailed control testing may be necessary.

Consideration of Whether to Test Controls. The auditor's response to identified fraud risks may include testing controls (see the discussion of specific responses in Lesson 3), but tests of controls alone cannot reduce audit risk to an appropriately low level. AU-C 330B.18 explains that regardless of the assessed risks 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. Thus, even if controls are tested, the auditor will need to perform some substantive procedures. As a practical matter, the authors believe many entities will not have designed and placed in operation antifraud programs and internal controls that sufficiently mitigate identified fraud risks. The auditor will need to select effective substantive procedures in the performance of his or her further audit procedures. When the audit approach to significant risks, which includes fraud risks, consists only of substantive procedures (that is, the auditor does not plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures (AU-C 330B.22).

Consideration of Controls Related to Misappropriation of Assets. As noted in AU-C 240B, the inadequacy of controls to prevent or detect misappropriation of assets, including fraudulent cash disbursements, increases the susceptibility of assets to theft. When considering fraud risk factors, the auditor may identify weaknesses in such controls, which create an opportunity for misappropriation to occur. If the auditor identifies a risk of material misstatement of the financial statements due to the misappropriation of assets, the auditor generally has already considered risk factors related to internal control, especially control deficiencies that exacerbate the risk by creating an opportunity for misappropriation to occur. If the auditor has identified such risk factors and concluded that a risk of *material* misstatement of the financial statements related to misappropriation exists, the authors believe it is unlikely that the auditor will be able to identify antifraud programs and controls sufficient to override the previous consideration of risk factors. The auditor will have to perform substantive procedures responsive to the fraud risk in the performance of his or her further audit procedures.

Responding to Fraud Risks

An auditor responds to fraud risks in at least one of three ways:

- Overall responses.
- Specific responses that involve the nature, timing, and extent of further auditing procedures.
- Responses to further address the risk of management override of controls.

Generally, the manner in which the auditor responds depends on (a) the nature and significance of the identified risks and (b) the programs and controls that address the risks.

Documenting Risks of Material Misstatement Due to Fraud

AU-C 240B.43–.46 requires the auditor to document the following:

- When the engagement team discussion regarding the entity's susceptibility to fraud occurred, who participated, and the significant decisions reached.
- Identified and assessed fraud risks at both the financial statement level and the assertion level.
- Overall responses to assessed fraud risks at the financial statement level; the nature, timing, and extent of audit procedures at the assertion level; and linkage of the risks with the procedures at the assertion level.
- The results of procedures, including those designed to address management override.
- Communications about fraud to management, those charged with governance, regulators, and others.
- If applicable, how the auditor overcame the presumption that improper revenue recognition is a fraud risk.

AU-C 240B does not specify the form of the documentation. The auditor may use a checklist, a memo, or a combination of both. AU-C 240B does not require a one-to-one correlation between risks and responses. That is, one response may address several fraud risks, and one risk may require several responses. Therefore, the responses to identified fraud risks may be documented individually or in combination. As with designing and performing responsive procedures generally, linkage of procedures with the assessed risks of material misstatement due to fraud at the assertion level is essential.

PREPARING A RESPONSE TO THE RISK ASSESSMENT AND DEVELOPING THE DETAILED AUDIT PLAN

AU-C 300B.09 indicates that the auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures.

b. The nature, timing, and extent of planned further procedures at the relevant assertion level.

c. Other planned procedures required by GAAS.

AU-C 330B.06 indicates that the further audit procedures the auditor designs and performs should be responsive to the assessed risks of material misstatement at the relevant assertion level. AU-C 330B.07 indicates that in designing further audit procedures, the auditor should consider the reasons for the assessed risk of material misstatement, including the related inherent risk and control risk, and obtain more persuasive evidence in higher risk areas. AU-C 330B.A18 adds that for audits of governmental entities, nature, timing, and extent of further auditing procedures may be affected by the audit mandate and any other special governmental audit requirements. For example, governmental audit requirements may require the auditor to perform tests of controls, even if reliance is not planned. AU-C 330B.A8 notes that the design and performance of audit procedures that are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level provides a clear linkage between the assessment and further audit procedures. The observations and suggestions to paragraph 5.37 of the AICPA Risk Assessment Audit Guide note that *linkage* describes the relationship between the assessed risks and further audit procedures. *Clear linkage* means that the further audit procedures are demonstrably responsive to the assessed risks. The 2018 AICPA Risk Resources analysis of peer review Matters for Further Consideration (MFCs) found that 24% of the matters identified were failures to adequately link the risk assessment to the response. The authors believe that peer reviewers can be expected to closely scrutinize audits for the adequacy of linkage, and auditors' risk assessments and responses need to reflect as well as document appropriate linkage of risk assessments and audit procedures planned and performed. One means of documenting linkage is to add a detailed explanation of how planned further audit procedures are responsive to the risk assessment by assertion in the linkage/comments column in the appropriate practice aid from *PPC's Guide to Audits of Local Governments*.

Specialized Considerations for Governmental Units

In considering assertions and procedures for a governmental engagement, it is useful to consider audit approach by the following broad categories:

- Governmental funds.
- Proprietary funds.
- Fiduciary funds.
- Reconciliation of funds statements to government-wide statements.
- Component units.

Proprietary funds (enterprise and internal service funds), as explained in Lesson 1, charge for services provided and have an accrual basis measurement focus. Because of this basic similarity to business enterprises, the audit approach explained in *PPC's Guide to Audits of Nonpublic Companies* is often efficient and effective, and many of the same audit programs can often be used. Also, capital assets and long-term debt have many similarities to those audit areas in the audit of a business enterprise. However, because of special considerations such as interfund transfers, in-relation-to opinions, grant programs, and accounting considerations unique to governmental units, specialized audit programs are advisable.

Determining the Audit Approach

Based on the assessments of the risks of material misstatement at the relevant assertion level, the auditor determines what further audit procedures need to be performed. For simplicity in the discussions throughout this course, the authors refer to the decisions of which further audit procedures will be performed as the selection of an audit "approach." An *approach* is defined as "the method used or steps taken in setting about a task, problem, etc. . . " In this course, the approach selected by the auditor to respond to the risk assessment (and documented on the practice aids provided in *PPC's Guide to Audits of Local Governments*, if desired) for relevant assertions within each audit area involves the following decisions:

- Performing only limited procedures and not developing a separate audit program.
- Choosing between core audit programs and specified risk audit programs.
- Performing basic procedures from the core audit program or performing basic procedures plus certain extended procedures from the core audit program.
- Performing procedures from the specified risk audit program.

The following paragraphs include initial considerations involved in choosing the appropriate audit approach and using the chosen approach. The authors anticipate that auditors will tailor all PPC audit programs for individual financial statement audit areas to respond to their client's specific risks and circumstances. Tailoring audit programs is discussed later in this section.

Performing Only Limited Procedures. The auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed for the audit area because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures approach and will be appropriate only for audit areas that are not significant. As previously explained, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

Choosing between Core Audit Programs and Specified Risk Audit Programs. The next decision to be made by the auditor is whether to use the core audit programs or the specified risk audit programs for a particular audit area or fund. Both sets of audit programs in *PPC's Guide to Audits of Local Governments* (i.e., core and specified risk) provide a starting point for the auditor to use in developing an audit response and determining the nature, timing, and extent of further audit procedures that need to be performed to respond to the risk assessment. Both sets of audit programs need to be tailored to respond to the individual risk assessment at the assertion level as discussed later in this section. The individual audit programs document audit procedures and the assertions relevant to each procedure and provide linkage to the assessed risks of material misstatement. The assessment of the risks of material misstatement by assertion assists the auditor when deciding on an appropriate audit response by providing linkage between the risks and related audit program procedures. As noted above, additional explanation of how further audit procedures respond to the risks of material misstatement by assertion may be provided in the linkage/comments column.

When deciding which approach is appropriate, it is important for the auditor to perform a careful review of the procedures in each program to ensure that the approach and the further audit procedures selected will appropriately respond to the assessed risk. The key to audit effectiveness and efficiency is to choose an audit approach that adequately responds to the identified risks without requiring more time commitments than necessary.

Using the Core Audit Programs. The PPC core audit programs, in *PPC's Guide to Audits of Local Governments*, include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the core audit programs for individual audit areas include the following sections:

- *Basic Procedures*, which include primarily substantive analytical procedures and certain tests of details, many of which are required by GAAS (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue recognition.)
- *Extended Procedures (Procedures for Additional Assurance)*, which include procedures from which the auditor can choose or develop one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.
- *Other Audit Procedures*, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other Audit Procedures are considered Extended Procedures when completing the "Risk Assessment Summary Form.")

Auditors using the core audit programs decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. This analysis is not a simple determination based on whether risk is high, moderate, or low. A low or moderate risk of material misstatement for an assertion indicates that a Basic Procedures approach may be appropriate for that assertion. The auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks, as well as client expectations. The particular tests selected, whether they are in the Basic Procedures or Extended Procedures section of the audit programs, need to be tailored to the nature, cause, and direction of potential misstatements at the relevant assertion level. It may also be appropriate to modify the extent or timing of the procedures to adequately respond to the risk assessment. If an audit area includes one or more significant risks, basic procedures will have to be modified or extended procedures added.

The Basic Procedures section of the core audit programs contains certain tests of details that may also be a response to a higher assessed level of risk for the related assertions. In other words, those procedures may provide additional assurance even though they are included in the Basic Procedures section rather than in the Extended Procedures section.

The Extended Procedures section of the core audit programs (additional assurance) is a source list of possible audit procedures and is not an alternative audit program. It is arranged by topic and includes a column indicating the assertions that are primarily and secondarily addressed by the procedure. The auditor selects procedures from the list that are needed to respond to the risk assessment. Selecting appropriate substantive procedures is discussed more fully in Lesson 3.

Using the Specified Risk Audit Programs. The authors developed the specified risk set of audit programs based on a set of underlying risk assumptions at the assertion level for most audit areas. The procedures in the specified risk audit programs come from the basic and extended procedures in the core audit programs. (All procedures in the specified risk programs are also in the core audit programs.) The programs include substantive procedures for audit areas (general ledger account groupings) common to many local governments. These programs are designed to increase audit efficiency by linking the financial statement assertions, risk assumptions, and procedures to identify those procedures that are common to many local government audit engagements. Tailoring the specified risk audit programs is discussed later in this lesson.

At the front of each specified risk audit program in *PPC's Guide to Audits of Local Governments*, is a description of the underlying risk assumptions for that audit area. Before selecting the specified risk approach and using the related programs, auditors ought to perform a careful review of the underlying risk assumptions and the procedures in each program to ensure that the further audit procedures selected appropriately respond to the assessed risk for a particular client.

The procedures provided in the specified risk audit programs are intended to apply to governments or engagements that have the following general characteristics:

- The auditor does not intend to rely on the operating effectiveness of controls to reduce the control risk assessment for any relevant assertions. Substantive procedures alone are effective in responding to the risk assessment.

- Accounting personnel are generally competent to process data and make decisions necessary to perform their assigned duties.
- No fraud risks are identified except the risks of improper revenue recognition and management override of controls. The risk of management override of controls is addressed in the general audit program.
- There are no known significant deficiencies or material weaknesses in the control environment that would require modification of the programs.
- Audit procedures are either performed entirely at year end or applied to transactions through an interim date and completed as part of year-end procedures (that is, audit conclusions are not extended from an interim date to the financial position statement date).
- A Yellow Book audit will be performed.
- A Single Audit will not be performed.

If the general characteristics listed in the previous paragraph do not apply to the particular engagement, auditors need to consider whether it is appropriate to use the specified risk approach or whether the basic or extended procedures approach using the core audit programs ought to be used. If the risk assessment for a particular relevant assertion differs from the assumed underlying risk assumptions, the auditor ought to consider the need to modify the audit program for that assertion to adequately respond to the risk assessment. If additional procedures are needed, they can be selected from the core audit programs. In some cases, it may be possible to adequately respond to a particular risk assessment by modifying the extent of procedures in the specified risk audit program rather than selecting additional procedures. Lesson 3 provides guidance on when the extent of procedures ought to be increased or additional procedures applied, as well as when it may be possible to eliminate, modify, or change the timing of procedures.

Documenting the Approach Selected. The practice aids in *PPC's Guide to Audits of Local Governments* provide space to document which approach the auditor has selected (Limited = "L", Basic = "B", Extended = "E", or Specified Risk = "S") and also a space to document comments that may be appropriate concerning the audit program, including the linkage between risks and responses. Of particular importance is the explanation of how the planned procedures are responsive to the specific assessed risks of material misstatement at the relevant assertion level. For significant risks (both fraud and other risks), an auditor may decide to prepare a separate memo that documents the manner in which the selected approach and procedures are responsive to the assessed risks of material misstatement.

Relation of Types of Substantive Procedures to the Approach Selected. The following paragraphs include discussions of the basic types of substantive procedures, provide guidance on selecting different audit approaches, and explain how to tailor the audit programs for an efficient and effective audit. Substantive procedures have historically been classified and described based on their nature, such as, for example, inspection, confirmation, or reperformance. This perspective is accurate, but does not help auditors determine the most efficient audit approach for responding to risks.

Exhibit 2-7 shows how the traditional types of substantive audit procedures fit into audit approaches. Note that some procedures may fit more than one approach depending on how they are applied. For example, analytical procedures, which may be used to test most relevant assertions, may be applied in any type of audit approach. On the other hand, reperformance, which is used primarily to test accuracy, valuation, or allocation but may be used to test existence/ occurrence, or completeness, is generally used only as a procedure for additional assurance. The following paragraphs discuss the types of procedures used in each audit approach. How to modify the types of procedures used in audit programs is discussed later in this lesson. Choosing appropriate substantive procedures is discussed in Lesson 3.

Exhibit 2-7

Relationship of Substantive Audit Procedures to Audit Approach

	Related Assertions[a]		Audit Approach[b]		
Procedure	**Primary**	**Secondary**	**Limited Procedures**	**Basic Procedures**	**Extended Procedures**
Inquiry	All assertions[c]		✓	✓	✓
Analytical procedures	All assertions		✓	✓	✓
Observation[d]	All assertions			✓	✓
Inspection of tangible assets	E/O	A/CL, V, R/O		✓	✓
Confirmation[e]	E/O, R/O	C, A/CL, V, CO		✓	✓
Inspection of documents	All assertions		✓	✓	
Reperformance and recalculation	A/CL, V, CO	E/O, C			✓

Notes:

[a] E/O—existence or occurrence; C—completeness; R/O—rights or obligations; A/CL—accuracy or classification; V—valuation or allocation; CO—cutoff.

[b] Some procedures fit more than one category depending on how they are applied.

[c] Inquiry needs to be supported by additional evidence. However, it is usually more efficient to corroborate responses to inquiries than to find answers independently through an undirected examination of detailed evidence.

[d] According to AU-C 501B.11, unless it is impracticable, the auditor should make or observe physical inventory counts. The authors believe that immateriality of inventory balances is the only reason not to observe or make physical counts of inventory. If inventory is not observed due to immateriality, the authors believe auditors ought to document that conclusion.

[e] AU-C 330B.20 and AU-C 505B.03 state that confirmation of accounts receivable is presumed [required] unless specified conditions are met. Thus, there is a presumption that the auditor will request confirmation of accounts receivable during the audit. If accounts receivable are not confirmed, AU-C 330B.32 requires auditors to document how they overcame that presumption.

Limited Procedures (Preliminary Analytical, Other Risk Assessment, and Final Analytical Procedures). Limited procedures consist of performing preliminary analytics, other risk assessment procedures, and final analytics only. These procedures are included in the general audit programs and are required to be performed on every engagement. Preliminary analytical procedures are normally simple analytical procedures, such as comparison of current and prior-year balances on the working trial balance or lead schedule. Limited procedures may also include inquiries of client personnel or other procedures to determine explanations for differences, as well as the risk assessment procedures applied to obtain an understanding of the client's business and fraud risks, management's response to those risks, and their effect on the audit. In the overall review stage of the audit, similar analytical procedures are applied to the audited financial statement amounts. Auditors can document their planned audit approach in each audit area by assertion. The Limited Procedures Approach may be sufficient for assertions for which the risks of material misstatement are low, such as immaterial asset balances. However, AU-C 330B.18 states that auditors should design and perform substantive procedures for all *relevant* assertions related to each *material* class of transactions, account balance, and disclosure. As a result, the limited procedures approach is not appropriate for significant audit areas.

<u>Basic Procedures.</u> The basic procedures section of the audit programs includes primarily substantive analytical procedures and certain tests of details, many of which are required by specific AU-C sections. The substantive analytical procedures are more than comparisons of recorded amounts to financial and nonfinancial information. The basic procedures also include the following:

- Scanning accounting records to identify unusual relationships or the absence of expected relationships.
- Inquiring of the client about relevant audit matters.
- Observing certain assets or client practices.
- Confirming information with third parties and performing other limited detail tests.

The basic procedures may be sufficient when the risk of material misstatement has been assessed as low or moderate for relevant assertions. These procedures need to be supplemented in areas of greater risk by selected extended procedures (procedures for additional assurance).

Basic procedures by themselves are not ordinarily appropriate to respond to a fraud risk or other significant risk. However, the following are examples of areas where basic procedures may be appropriate to respond to high risks:

- *Confirmation of Receivables.* Confirming receivables, which is a basic procedure in the audit program for sales and service revenue and receivables—proprietary funds, may be an appropriate response to high risks related to the existence of receivables.
- *Search for Unrecorded Liabilities.* A search for unrecorded liabilities, which is a basic procedure in the audit program for expenditures/expenses for goods and services and accounts payable and other liabilities, may be an appropriate response to high risks related to the completeness of liabilities.

In those cases, the auditor needs to carefully consider the extent and timing of the basic procedures when responding to the greater risk.

<u>Extended Procedures (Procedures for Additional Assurance).</u> By selecting the Extended Procedures approach, the auditor is indicating that he or she will perform the basic procedures plus selected extended procedures (procedures for additional assurance) or other audit procedures. Extended procedures consist primarily of the following types of substantive procedures:

- *Tests of Details.* These are procedures, such as vouching, tracing, reperformance, or confirmation, that are applied to individual transactions or items in balances. There are two primary types of tests of details:
  - *Tests of Transactions.* These are tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing or reperforming client routines.
  - *Tests of Balances.* These are tests applied directly to the details of balances in general ledger accounts, for example, confirming the balances of accounts in the accounts receivable subsidiary ledger with individual customers. Generally, tests of balances are more efficient and effective than tests of transactions.
- *Substantive Analytical Procedures.* These analytical procedures may be similar to those discussed above in relation to limited procedures. However, they are performed at a greater level of precision and are typically performed at a very detailed (disaggregated) level. A discussion on choosing between analytical procedures and tests of details is located in Lesson 3.

These procedures generally provide a greater degree of audit assurance, and one or more extended procedures are typically selected to supplement the basic procedures when responding to a higher-risk assertion. Basic Procedures alone are generally not enough to respond to significant risks. Because every audit can be expected to have one or more significant risks, one or more audit areas will require a response that includes the Extended Procedures approach for relevant assertions affected by the significant risk. An auditor will also need to do some additional tailoring of the Basic Procedures and Extended Procedures in response to specific risks of material misstatement at the relevant assertion level because a standardized audit program cannot be fully responsive to significant risks.

Specified Risk Procedures. The specified risk programs have been developed from the basic and extended procedures in the core audit programs. (All procedures in the specified risk programs are also in the core audit programs.) The programs have been developed based on a predefined set of risk assumptions and include procedures typical in a local government audit entity.

Tailoring the Audit Programs

Previously, this lesson explained how the auditor identifies and assesses risks in the audit. The auditor identifies risks (including risk of material misstatement due to fraud), considers management's response to those risks through operating decisions and controls, and assesses the risks of material misstatement at the relevant assertion level. The key to efficient and effective auditing is selecting procedures for each relevant assertion that responds to its respective risks. Simply stated, this means spending more audit effort responding to the higher-risk assertions and less audit effort in responding to the lower-risk assertions. This section explains how to use the audit programs in *PPC's Guide to Audits of Local Governments* for efficient auditing that meets the requirements of the authoritative standards. Lesson 3 includes a more detailed discussion on the substantive procedures required by specific AU-C sections in every audit; the nature, timing, and extent of substantive procedures; and choosing the appropriate mix of substantive analytical procedures and tests of details.

As discussed previously, *PPC's Guide to Audits of Local Governments* provides three sets of audit programs:

- *Core Audit Programs.*
- *Specified Risk Audit Programs.*
- *Initial Audit Programs.*

Core and Specified Risk Programs Provide Starting Points. The core and specified risk audit programs provide two different starting points for auditors to use in developing an audit response and determining the nature, timing, and extent of further audit procedures that need to be performed in response to the risk assessment at the relevant assertion level. The observations and suggestions to paragraph 5.37 of the AICPA Risk Assessment Audit Guide note the importance of modifying audit programs as necessary to ensure that substantive procedures are clearly linked to assessed risks. Both the core and specified risk audit programs need to be tailored to respond to the individual risk assessment. As previously discussed, it is important for the auditor to perform a careful review of the procedures in each program when deciding which program to start with for a particular client or audit area. It is anticipated that auditors will tailor all the PPC audit programs for individual audit areas to respond to their client's specific risks and circumstances.

Initial Audit Programs. The initial audit programs include additional procedures necessary in an initial audit engagement. All of the procedures in initial audit programs are extensions of the procedures in the core audit programs and the specified risk audit programs and generally are performed in conjunction with those programs. The initial audit programs include both general audit programs and audit programs for individual financial statement audit areas. The general procedures program includes the following sections:

- *Additional General Planning Procedures for an Initial Audit*, including procedures such as obtaining the client's permission to review the predecessor's workpapers and files, reviewing significant legal documents, etc.
- *Additional General Auditing and Completion Procedures for an Initial Audit*.

The initial audit programs for individual audit areas include procedures relating to review of a predecessor auditor's workpapers and certain other procedures. Tailoring of the initial audit programs is generally related to whether information from a review of the predecessor auditor's workpapers will be used as evidence for opening balances.

Tailoring Core Audit Programs. The PPC core audit programs include both general audit programs and audit programs for individual financial statement audit areas.

Tailoring General Procedures. The general procedures programs consist of the following sections:

- *General Planning Procedures*, including engagement acceptance procedures, the procedures for obtaining an understanding of the entity and its environment, including internal control, assessing the risk of material misstatement, determining planning materiality, etc.
- *Other General Planning Procedures*, including planning procedures related to matters such as using the work of specialists, group audits, and use of service organizations.
- *General Auditing and Completion Procedures*, including procedures required by specific AU-C sections that do not relate to particular account balances, such as testing of journal entries, evaluation of misstatements, and obtaining legal representation letters.
- *Other General Auditing and Completion Procedures*, including procedures that may be warranted due to specific circumstances, such as potential fraud or violations of laws and regulations, related party transactions, accounting estimates, omitted procedures and subsequent discovery of facts, etc.
- *Federal Award Programs—General Procedures*, including general procedures necessary in a Single Audit.

The audit programs for general procedures cover the general steps performed in any audit. Tailoring generally involves removing or adding procedures to fit the specific circumstances of the engagement.

The audit programs for individual financial statement audit areas are designed to correspond with the auditor's risk assessments and decisions about the audit approach at the assertion level. If using the practice aids provided by *PPC's Guide to Audits of Local Governments*, the auditor uses them to document significant audit areas, the risks of material misstatement affecting relevant assertions for account balances, transaction classes, or disclosures included in each audit area (including fraud risks or other significant risks), the assessment of those risks at the assertion level, the planned audit approach that is appropriately tailored to respond to the assessed level of risk, and the linkage of the assessed risks to the audit procedures that respond to those risks.

Selecting Extended Procedures (Procedures for Additional Assurance). An auditor needs to decide which extended procedure(s) are needed. The auditor ought to select procedures that are most appropriate to respond to the risk assessment. To help auditors in selecting appropriate procedures and to show linkage between the assessed risk and the further audit procedures performed to respond to the risk, each procedure on the audit programs indicates the assertions that are primarily and secondarily addressed by that procedure. Also, the auditor indicates the choice of a procedure by placing a checkmark in the box provided. For example, auditors who identify a high risk relating to the completeness of service accounts receivable can scan the list of procedures for additional assurance in the "Audit Program for Service Revenue and Receivables—Proprietary Funds" looking for procedures relating to completeness. If an appropriate procedure is identified in the extended procedures section of the audit program, the auditor would place a checkmark in the box indicating that procedure has been selected to address the risk. If the procedure addresses more than one assertion, the auditor might also highlight the "C" in the assertion column or otherwise indicate that completeness is the assertion being specifically tested. Some extended procedures are specifically identified for consideration in response to identified fraud risks. If the auditor determines that the risk of material misstatement has not been responded to adequately after performing procedures or if there is not a procedure in the audit program that responds to the identified risk, the auditor needs to develop an appropriate response by editing or adding audit program steps.

The selection of extended procedures needed to respond to a particular risk is a matter of auditor judgment. When making those decisions, the auditor considers the factors discussed in Lesson 3.

Even high-risk assertions can be overaudited. Only rarely would an auditor need to perform all the extended procedures for an audit area. The auditor focuses on the extended procedures that relate to the risks identified for that area and, as previously noted, the auditor selects additional procedures based on the assessment of risk of material misstatement at the relevant assertion level.

When the auditor is selecting extended procedures, the goal is to find the appropriate mix of analytical procedures and tests of details to respond to the risk of material misstatement. The auditor selects extended procedures to supplement the basic procedures. However, sometimes the selected steps in the extended procedures section can replace one of the steps in the basic procedures section. The auditor need not apply certain procedures in the basic procedures section if other planned procedures are sufficient to reduce the risk of material misstatement to an appropriately low level.

Tailoring Specified Risk Audit Programs. The specified risk programs have been developed from the basic and extended procedures in the core audit programs. All procedures in the specified risk programs are also in the core audit programs. Generally, the audit procedures in the specified risk programs are more focused on substantive tests of details versus substantive analytics. The programs have been developed based on a predefined set of risk assumptions and include procedures that are typical in a government engagement. The assumptions include that (a) a Yellow Book audit will be performed and (b) a Single Audit will not be performed. If the general characteristics listed earlier in this section do not apply to the engagement, the auditor considers whether it is appropriate to use the core audit programs instead, or a combination as discussed below.

The specified risk programs, similar to the core audit programs, include both general audit programs and audit programs for individual financial statement audit areas. The general audit programs consist of general planning procedures and the general auditing and completion procedures. The other general planning procedures and other general auditing and completion procedures are not included in the specified risk programs. If the auditor has a particular circumstance covered in the other sections of the general audit programs, he or she will need to go to the core programs and pull in the steps needed to fit the specific circumstances of the engagement.

The audit programs for the individual audit areas in the specified risk programs consist of one set of procedures, developed from the basic and extended procedures in the core audit programs. At the front of each specified risk audit program is a description of the underlying risk assumptions by assertion for that audit area. Before selecting the specified risk approach and using the related programs, the auditor performs a careful review of the underlying risk assumptions and the procedures in each program to ensure that the audit procedures included in the program appropriately respond to the risk assessment for a particular client or relevant assertion.

If the risk assessment for a particular assertion differs from the assumed underlying risk assumptions, the auditor considers how to modify the audit program for that assertion to adequately respond to the risk assessment. If additional procedures are needed, they can be selected from the basic, extended, and other procedures included within the core audit programs. (The core audit programs designate with an "S" those steps that have already been included in the specified risk audit programs.) As discussed in detail in Lesson 3, in some cases, it may be possible to adequately respond to a particular risk assessment by altering the extent or timing of procedures rather than selecting additional procedures. Also, as noted previously, depending on the assessed risks, the auditor might need to edit or add other audit program steps for an adequate audit response. Similar to the tailoring of core audit programs, identification and assessment of a significant risk in an audit area of a specified-risk audit program will require the modification or addition of procedures that are responsive to the risks of material misstatement for the affected relevant assertions.

SMART Start provides an illustrative set of internal control documentation and a set of audit programs that are pre-tailored based on pre-defined characteristics applicable to smaller, less complex governmental entities. For such entities, SMART Start provides a starting point that is comparable to the specified risk audit programs and can be tailored by comparing the characteristics unique to the auditor's engagement to those specified in SMART Start.

Using a Combination of Core Audit Programs and Specified Risk Audit Programs. There may be circumstances in which the auditor decides to use a combination of core audit programs and specified risk audit programs for different audit areas. For example, assume the auditor has performed the risk assessment, performed a thorough review of the assumptions and procedures in the specified risk audit programs, and decided that the specified risk approach appropriately responds to the risk assessment for the client for all relevant assertions in all audit areas except Cash. In that case, the auditor could use the specified risk programs for all of the audit areas except Cash. For Cash, the auditor would develop the audit program for Cash from the core audit programs and indicate on the risk assessment summary form that either a basic or extended procedures approach was selected for Cash.

Documentation Requirements

AU-C 330B.30 requires the auditor to document the following related to preparing the detailed audit plan:

- Overall responses to the assessed risks of material misstatement at the financial statement (i.e., opinion unit) level.
- Nature, timing, and extent of further audit procedures performed.
- Linkage of the procedures performed with the assessed risks at the relevant assertion level.
- Results of the audit procedures performed, and conclusions that are not otherwise clear.

As noted earlier in this section, AU-C 300B.09 states that the audit plan should include the following:

- A description of the nature and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure.
- A description of other audit procedures planned to be carried out for the engagement in order to comply with generally accepted auditing standards (for example, seeking direct communication with the entity's lawyers).

Planning continues throughout the audit, and performance of risk assessment or other procedures may cause a change in planned further audit procedures. As previously discussed, AU-C 300B.10 notes that the auditor should document changes to the original audit plan. The practice aids provided in *PPC's Guide to Audits of Local Governments* were designed to assist the auditor in meeting these documentation requirements.

SELF-STUDY QUIZ

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

14. Which of the following small governments has intentionally misstated its revenue?

    a. Government A recognizes significant revenues on the accrual basis.

    b. Government B net revenue against expenses/expenditures.

    c. Government C recognizes revenue from cost reimbursement grants for costs incurred.

    d. Government D records revenue in the wrong fund.

15. When using the PPC audit approach, which of the following is a core audit program that includes primarily substantive analytical procedures and certain tests of details?

    a. Limited procedures.

    b. Basic procedures.

    c. Extended procedures.

    d. Other audit procedures.

16. Auditors are required to document all of the following related to preparing the detailed audit plan **except**:

    a. The nature, timing, and extent of further audit procedures performed.

    b. Linkage of procedures performed with overall responses to assessed risks.

    c. Results of the audit procedures that were performed.

    d. Overall responses to the assessed risks of material misstatement at the opinion unit level.

SELF-STUDY ANSWERS

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

14. Which of the following small governments has intentionally misstated its revenue? **(Page 242)**

    a. Government A recognizes significant revenues on the accrual basis. [This answer is incorrect. Management of a small government night intentionally misstate revenue by recognizing significant revenues on a cash basis instead of accrual or modified accrual basis.]

    b. Government B net revenue against expenses/expenditures. [This answer is incorrect. Failing to net revenue against expenses/expenditures when required (e.g., when insurance recoveries are received in the same year as an impairment loss) is one way that a small government's management might intentionally misstate revenue.]

    c. Government C recognizes revenue from cost reimbursement grants for costs incurred. [This answer is incorrect. Recognizing revenue from cost reimbursement grants for costs that were *not* incurred is one way the management of a small government might intentionally misstate revenue.]

    d. **Government D records revenue in the wrong fund. [This answer is correct. Some auditors have indicated that the risk of improper revenue recognition by a governmental entity is almost nonexistent because of the nature of a government's revenues. However, auditors should presume that the risk exists. In a small government, one way management might intentionally misstate revenue is by recording it in the wrong fund.]**

15. When using the PPC audit approach, which of the following is a core audit program that includes primarily substantive analytical procedures and certain tests of details? **(Page 247)**

    a. Limited procedures. [This answer is incorrect. Using limited procedures means that no separate specific audit program is needed for an audit area because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. The use of limited procedures is not one of the core audit programs when using the PPC audit approach.]

    b. **Basic procedures. [This answer is correct. As part of the core audit programs (which are used in the PPC audit approach), the basic procedures include primarily substantive analytical procedures and certain tests of details, many of which are required by GAAS (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue recognition.]**

    c. Extended procedures. [This answer is incorrect. The extended procedures are procedures for additional assurance, which include procedures from which the auditors can choose or develop one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.]

    d. Other audit procedures. [This answer is incorrect. These include procedures that may be warranted due to the specific circumstances of the engagement, as opposed to those above which would typically be used in most engagements.]

16. Auditors are required to document all of the following related to preparing the detailed audit plan **except**: **(Page 255)**

    a. The nature, timing, and extent of further audit procedures performed. [This answer is incorrect. According to AU-C 330B.30, auditors are required to include this in their documentation.]

    b. **Linkage of procedures performed with overall responses to assessed risks. [This answer is correct. Per AU-C 330B.30, the auditor is required to document four things in relation to**

preparing the detailed audit plan. One of those things is linkage of the procedures performed with the assessed risks at the relevant assertion level.]

c. Results of the audit procedures that were performed. [This answer is incorrect. Results of the audit procedures performed and conclusions that are not otherwise clear should be documented per AU-C 330B.30.]

d. Overall responses to the assessed risks of material misstatement at the opinion unit level. [This answer is incorrect. According to AU-C 330B.30, auditors are required to document overall responses to the assessed risks of material misstatement at the financial statement (i.e., opinion unit) level.]

Lesson 3: Substantive Procedures

INTRODUCTION

Lesson 3 continues this course's look at some of the important considerations that affect governmental audit engagements by focusing on substantive procedures. Among other things, Lesson 3 discusses the substantive procedures required in every audit, those auditors may choose for a particular engagement, and how to determine when tests of details or substantive analytical procedures are needed.

Further audit procedures performed for the purpose of detecting material misstatements at the relevant assertion level are referred to as substantive procedures. For each relevant assertion within a material account balance, class of transactions, or disclosure, the auditor needs to determine the nature, timing, and extent of substantive procedures necessary to obtain sufficient, appropriate audit evidence to express an opinion on the financial statements. Substantive procedures consist of tests of details and substantive analytical procedures, both of which are discussed in more detail in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify what substantive procedures are required in every audit and how to choose other substantive procedures.
- Recognize best practices for tests of details and substantive analytical procedures.
- Determine what other issues may arise related to substantive procedures and what timing for such procedures is appropriate.

Specialized Considerations for Governmental Units

In planning further audit procedures for an audit of a governmental entity, auditors need to consider both the government's use of funds and the auditor's requirement to report on opinion units. Because governmental units usually maintain multiple funds, audit efficiency is lost if auditors perform repetitive procedures on funds. When possible, auditors can avoid repetitive procedures by designing audit procedures that can be applied to multiple funds.

Auditors should also design and perform the further audit procedures so that appropriate evidence is provided for a separate opinion on each opinion unit. When an auditor performs audit procedures based on the government's transaction cycles (e.g., the cash disbursements cycle), the procedures should be designed to give appropriate coverage to each opinion unit. Frequently, a government's internal control system for a transaction cycle is the same regardless of where the transactions and balances are reported in the financial statements. When this is the case, the auditor's consideration of internal control for that transaction cycle would apply equally to all applicable opinion units.

Considerations in a Single Audit

The Single Audit Act Amendments of 1996 and OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) require the auditor performing a Single Audit to test compliance with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major federal award program. In addition, AU-C 935B, *Compliance Audits*, which is applicable in a Single Audit, requires the auditor to perform tests of details, which may include tests of transactions, in response to the assessed risks of material noncompliance. The Uniform Guidance, at 2 CFR section 200.514(d)(4), requires that compliance testing include tests of transactions and other auditing procedures necessary to support an opinion on compliance. Tests of transactions for compliance with requirements applicable to federal award programs are substantive procedures. As such, the auditor needs to consider the guidance in this lesson when performing a Single Audit. An in-depth discussion of testing compliance in a Single Audit is beyond the scope of this course, but more information is available in *PPC's Guide to Audits of Local Governments*.

Authoritative Literature

The authoritative pronouncements establishing requirements that most directly affect designing substantive procedures are as follows:

a. AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud, and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

b. AU-C 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, addresses designing and performing audit procedures that are responsive to risks at the relevant assertion level.

c. AU-C 500B, *Audit Evidence*, describes audit procedures used to obtain audit evidence.

d. AU-C 505B, *External Confirmations*, explains the auditor's use of external confirmation procedures to obtain audit evidence.

e. AU-C 520B, *Analytical Procedures*, explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.

f. AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), provides guidance on applying GAAS to audits of governmental financial statements. It also discusses accounting pronouncements and recognized practices that are unique to governments.

In the period from May 2019 to April 2020, the ASB issued SAS Nos. 134 to 140, which were discussed in Lesson 1. In May 2020, the ASB released SAS No. 141, *Amendments to the Effective Dates of SAS Nos. 134–140*, that delayed the effective dates of those standards to provide audit firms more time to implement them in light of the COVID-19 pandemic. The effective dates were delayed for one year for audits of financial statements for annual reporting periods ending on or after December 15, 2021. Early implementation is permitted, but the ASB recommends that the reporting standards, SAS Nos. 134, 136, 137, 139, and 140, be implemented concurrently, as a suite, to accommodate the transition to the new audit reporting model implemented by SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. The new SASs are fully incorporated in this edition of the course, with dual guidance provided for the reporting standards as applicable.

THE SUBSTANTIVE PROCEDURES THAT ARE REQUIRED IN EVERY AUDIT

Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, the auditing standards prescribe certain substantive procedures that should be performed in every audit. The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances.

Material Account Balance, Transaction Class, or Disclosure

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. According to AU-C 330B.18, no matter what the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. Even if the auditor assesses risks of material misstatement as low for a relevant assertion related to a material account balance, transaction class, or disclosure based on risk assessment procedures and tests of controls, some substantive procedures are still required, but may be substantive analytical procedures. Furthermore, for risks related to relevant assertions assessed as significant risks, if the audit approach consists only of substantive procedures, AU-C 330B.22 requires the auditor to perform some tests of details rather than placing reliance entirely on substantive analytical procedures.

The authors believe that the reasons for the requirements to always perform some substantive procedures for all relevant assertions for each material class of transactions account balance or disclosure are as follows:

- The auditor's assessment of risk is judgmental and might not be sufficiently precise to identify all risks of material misstatement.
- There are inherent limitations on the effectiveness of internal control, including management override, and even effective internal controls reduce but do not eliminate risks of material misstatement.

Other Required Procedures

Financial Close and Reporting Process. AU-C 330B.21 requires that the auditor perform the following substantive procedures in every audit:

- Agree or reconcile the financial statements, including the accompanying notes, to the underlying accounting records. (AU-C 330B.33 notes that the auditor's documentation should demonstrate that agreement or reconciliation.)

  SAS No. 134 amended AU-C 330.21 to agree or reconcile information in the financial statements, including the disclosures, with the underlying accounting records whether such information is obtained from within or outside of the general and subsidiary ledgers. SAS No. 134 amended AU-C 330.33 to require the auditor to document such procedures.
- Examine material journal entries and other adjustments made during the course of preparing the financial statements.

Governments often maintain accounting systems on a basis of accounting other than GAAP and prepare journal entries supported by worksheets to convert accounting system information as needed for the basic financial statements. SLG, Paragraph 4.92, explains that the nature and extent of the examination of journal entries and other adjustments will depend on the nature and complexity of the financial reporting system and the associated risks of material misstatement.

SLG, Paragraph 4.37, explains that many governments maintain their primary accounting records based on funds and then use a separate process to develop additional information necessary for their government-wide financial statements. As a result, the auditor may find it efficient to plan and perform the audit by considering fund financial statements first, and only then considering the additional information developed for government-wide financial statements. The additional information is generally of the following two broad categories:

- Reconciliations between fund financial statements and government-wide financial statements, such as capital asset and long-term debt information, and asset and liability accruals.
- Eliminations and reclassifications of internal activity and classifications of program and general revenues.

The auditor should obtain an understanding of (a) the processes used to prepare additional information developed for the government-wide financial statements and (b) the controls over those processes and the additional information, as well as considering the processes and controls over the fund financial statements. This understanding is important in planning and performing procedures applied to both the fund financial statements and the additional information. The auditor, in order to comply with AU-C 330B.21 needs to apply substantive procedures to the reconciliations between the fund financial statements and the government-wide financial statements, and the elimination, reclassification, and classification entries.

Management Override of Controls. AU-C 240.32, as amended by SAS No. 135, also requires certain substantive procedures in all audits to address the risk of management override of controls. These required procedures are as follows:

- Examine journal entries and other adjustments for evidence of possible material misstatement due to fraud, including—
  - Obtaining an understanding of the financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of those controls.
  - Inquiring of employees involved in the financial reporting process about inappropriate or unusual journal entry activity related to the processing of journal entries and other adjustments.
  - Considering fraud risk factors, the nature and complexity of accounts, and unusual entries processed.
  - Selecting journal entries and other adjustments made at the end of the reporting period.
  - Considering the need to test journal entries and other adjustments made throughout the period.
- Review accounting estimates for biases that could result in material misstatement due to fraud, including—
  - Evaluating whether management's judgments and decisions, even if they are individually reasonable, indicate possible bias that may represent a material misstatement due to fraud and, if so, reevaluating the accounting estimates as a whole.
  - Performing a retrospective review of management's judgments and assumptions related to significant prior-year accounting estimates.
- Evaluate the business purpose (or the lack thereof) of significant unusual transactions, including—
  - Read the documentation for the transaction and evaluate whether the information is consistent with explanations obtained from inquiries and other audit evidence about the transaction's business purpose (or the lack thereof).
  - Determine whether the entity's policies and procedures for authorization and approval of the transaction were followed.
  - Evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

Procedures relating to responding to fraud risks, including management override of controls, are discussed later in this lesson.

Both AU-C 330B.21 and AU-C 240B.32 require examining journal entries and other adjustments, but the requirement of AU-C 240B.32 is focused on identifying fraudulent journal entries. As discussed in paragraph 6.89 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide), the nature, timing, and extent of procedures required by AU-C 240B are different from those required by AU-C 330B. AU-C 330B focuses on journal entries made during the course of preparing the financial statements and AU-C 240B requires the auditor to consider reviewing journal entries made throughout the year. This distinction is also emphasized in a nonauthoritative AICPA Technical Question and Answer, *Examining Journal Entries* (Q&A 8200.16). Auditors should ensure that their audit procedures satisfy both requirements. Review of journal entries is discussed in more detail later in this lesson.

Significant Risks. As discussed in Lesson 2, significant risks are risks that require special audit attention. SLG, Paragraph 4.61, provides the following examples of significant risk areas pertaining to government audits:

- Valuation of derivative instruments and alternative investments.
- Landfill and pollution remediation liability estimates.
- Other postemployment benefits (OPEB) and pension disclosures.

- Valuation of OPEB and pension liabilities.
- Tax, grant, and donor restrictions.

If the auditor determines that a risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the audit approach to significant risks consists only of substantive procedures (that is, the auditor does not plan to rely on controls), the substantive procedures should be tests of details only or a combination of tests of details and substantive analytical procedures. The use of only substantive analytical procedures is not permitted. (AU-C 330B.22)

Other Specific Requirements. There are also presumptively mandatory requirements for substantive procedures for particular account balances. Examples include the following:

- Confirmation of accounts receivable. (AU-C 330B.20)
- Inventory observation, that is, being present at the time of the count and, by suitable observation, tests, and inquiries being satisfied about the effectiveness of the methods of inventory taking. (AU-C 501B)

In addition, there are other specific requirements to perform procedures, typically called *general procedures*, that do not relate to particular account balances, such as performing a review for subsequent events and reading minutes of meetings of those charged with governance. Those general procedures, as well as the required procedures listed in this lesson, are included in the general audit programs provided in *PPC's Guide to Audits of Local Governments*, if the auditor chooses to use them.

Documentation

AU-C 330B.30 and AU-C 240B.44 require the auditor to document the following items relating to substantive procedures, including responses to fraud risks:

- The nature, timing, and extent of substantive procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the procedures, including procedures to address the risk of management override of controls.

Though outside the scope of this course, basic audit documentation is discussed in *PPC's Guide to Audits of Local Governments*. Documentation considerations specifically relating to substantive procedures are discussed throughout this lesson.

CHOOSING SUBSTANTIVE PROCEDURES FOR THE ENGAGEMENT

Considering the Sufficiency and Appropriateness of Audit Evidence

The additional substantive procedures that are needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Therefore, the auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures. AU-C 500B.05 describes these characteristics of audit evidence as follows:

- *Sufficiency* is the measure of the *quantity* of audit evidence.
- *Appropriateness* is the measure of the *quality* of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

The quantity and quality of audit evidence needed are interrelated and are dependent on the risk of material misstatement.

The auditor performs risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement. This assessment includes consideration of the effectiveness of management's responses and controls to address risks. The auditor evaluates the quality and quantity of the evidence obtained from the risk assessment procedures and, if applicable, tests of controls to determine the further audit procedures necessary to obtain sufficient, appropriate evidence to afford a reasonable basis for an opinion on the financial statements under audit.

An important quality of audit evidence is its reliability, which is affected by both the nature and source of the evidence. AU-C 500B.A32 provides the following generalizations about the reliability of audit evidence:

a. Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.

b. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.

c. Audit evidence obtained directly by the auditor (for example, observation of the physical evidence of inventory stored at a third-party warehouse) is more reliable than audit evidence obtained indirectly or by inference (for example, confirmation with the custodian).

d. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. For example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.

e. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, faxes, or electronic images. Electronic images can include documents that have been filmed, digitized, or otherwise transformed into an electronic form. The reliability of electronic images may depend on the controls over their preparation and maintenance.

The generalizations in AU-C 500B.A32 do not provide guidance on situations in which there is a choice of available information. For example, there may be both information obtainable from knowledgeable independent sources and information obtainable directly by the auditor. An auditor needs to evaluate carefully the information that is relevant and reliable for the relevant assertion in the circumstances.

Authoritative literature views audit evidence as being obtained from a variety of sources, including the auditor's assessment of risk. AU-C 500B.05 defines audit evidence as "information used by the auditor in arriving at the conclusions on which the auditor's opinion is based." AU-C 500B.05 also indicates that audit evidence includes the information contained in the underlying accounting records and other information. AU-C 315B.21 notes for material account balances, the auditor should obtain an understanding of the reconciliation process of comparing detailed records to the general ledger. Further, as described earlier in this lesson, agreeing the financial statements to the underlying accounting records is a required procedure in every audit. Thus, without adequate attention to the propriety and accuracy of underlying accounting data, an opinion on the financial statements is not warranted. Audit evidence includes evidence obtained from procedures performed during the current audit as well as previous audits. Use of audit evidence from previous audits is discussed later in this lesson, but one common form of such evidence is experience gained in previous audits with respect to potential misstatements. Misstatements detected in previous audits are an important indicator of likely misstatements in the current audit. Generally, however, previous misstatements are a more reliable indicator of error than fraud.

AU-C 500B.10 states that if audit evidence obtained from different sources is inconsistent or doubt exists about the reliability of information to be used as audit evidence, the auditor should determine what changes or additions to audit procedures are necessary to resolve the matter and consider the effects on other aspects of the audit. The auditor needs to be wary when explanations obtained from different sources conflict, management's explanations for significant fluctuations differ from the auditor's expectations, or responses to inquiries about analytical relationships are vague, implausible, or inconsistent with the auditor's knowledge or other audit evidence. In this area, the main ingredients for effectiveness are healthy doses of common sense and professional skepticism.

Nature, Timing, and Extent of Substantive Procedures

As the residual risk of material misstatement increases, the quantity and quality of necessary audit evidence from substantive procedures also increase. The higher the auditor's assessment of risk, the more reliable and relevant audit evidence from substantive procedures needs to be. This may affect both the combination of audit procedures and the types of audit procedures to be performed.

Generally, the auditor will have decided whether audit procedures will be performed at an interim date or at period end as part of establishing the overall audit strategy. Therefore, in designing further audit procedures, the focus will be on the nature and extent of substantive procedures rather than their timing. AU-C 330B.A5 notes that a most important part of responding to the assessed risks is the nature of audit procedures. Generally, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk. Therefore, the nature of the audit procedure is a very important consideration.

Basic Types of Substantive Procedures

Substantive procedures have historically been classified and described based on their nature, as shown in Exhibit 3-1. This perspective is a sound approach to basic auditing, but it does not help auditors determine the most efficient audit approach for responding to risks. Selecting appropriate substantive procedures is discussed in the following paragraphs.

Exhibit 3-1

Substantive Audit Procedures (by Nature)

Procedure	Description	Examples
Inspection of tangible assets (physical examination)	Identification of an item's existence and sometimes its quality.	Test counts of inventory, cash count, securities count.
Confirmation	Obtaining a written response directly from independent parties outside the client organization in a paper form or by electronic or other means.	Confirming accounts receivable with utility customers.
Inspection of documents (including vouching and tracing)	Inspection of documents (vouching) that support recorded transactions or amounts. (Direction of testing is from recorded amount to the supporting document.) Tracing source documents to the amounts in the accounting records. (Direction of testing is from source document to recorded amount.)	Vouching recorded revenue transactions with billing documents for agreement.
Reperformance and recalculation	Auditor repetition of client routines, processes, or control procedures such as calculating and bookkeeping functions.	Determining that journal entries have been posted to the proper accounts; recomputing client depreciation calculations.
Inquiry	Questioning management, employees, or persons outside the entity (responses to which may be oral or written).	Obtaining a client representation letter.

Procedure	Description	Examples
Analytical procedures (including scanning)	Systematic analysis and comparison of plausible relationships among absolute amounts, trends, and ratios. Visual scrutiny of accounting records, reports, and schedules (scanning) to detect unusual items, inconsistencies, or anomalies, including investigation of differences that are inconsistent with expected values.	Comparing gross margin percentages over time; relationship of bad debt write-offs to the accounts receivable balance. Scanning the charges to the repairs expense account for capital expenditures; scanning the year-end revenue journal for unusual items.
Observation	Visually reviewing client activities or locations.	Observing bookkeeping routines; touring facilities.

Selecting Appropriate Substantive Procedures

The selection of specific substantive procedures involves consideration of all relevant factors, including the following:

- Characteristics of the related account (or transaction class).
- Financial statement assertion(s) being tested.
- Nature of risks identified.
- Degree of the risk involved.
- Type and persuasiveness of the available audit evidence.
- Efficiency and effectiveness of the substantive procedures.

Choosing between Substantive Analytical Procedures and Tests of Details

Substantive procedures include tests of details and substantive analytical procedures, and designing the nature of substantive procedures includes deciding on an efficient and effective combination of the two. In some cases, substantive procedures might be limited to substantive analytical procedures. Substantive analytical procedures alone are more likely to be appropriate in the following circumstances:

- The risks of material misstatement, including particular risks due to fraud, are relatively low.
- The account balance, transaction class, or disclosure relates to large volumes of transactions that tend to be predictable over time.
- The account balance, transaction class, or disclosure is not affected by a significant degree of subjectivity.

The authoritative literature does not explain how to apportion reliance on substantive procedures between tests of details and analytical procedures except for the prohibition against using substantive analytical procedures alone when testing significant risks. Analytical procedures may be used to reinforce conclusions based on the results of other substantive procedures or as the sole source of evidence. That decision is primarily based on the effectiveness of the procedures. Efficiency also may be a factor in deciding between analytical procedures and tests of details. That is, given two procedures of equal effectiveness, the auditor chooses the one that is most efficient. The auditor would ordinarily use an analytical procedure rather than a test of details if the analytical procedure is at least as effective in reducing detection risk to the desired level as the test of details and is easier to apply.

General Considerations. According to AU-C 520B.05, in designing substantive analytical procedures, the auditor should consider matters such as the following:

a. The suitability of using substantive analytical procedures given the nature of the assertion.

b. The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. [AU-C 500B.09 indicates the auditor should obtain audit evidence about the accuracy and completeness of information (both financial and nonfinancial) used in performing substantive analytical procedures.]

c. Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.

d. The amount of any difference between recorded amounts and expected values that is acceptable.

Generally, the higher the assessed risk of material misstatement of a particular assertion, the more effective analytical procedures need to be before they can be relied on instead of tests of details. Accordingly, auditors typically use tests of details more extensively in high risk audit areas (such as areas containing fraud risks or other significant risks) and analytical procedures more often in low risk areas or as secondary rather than primary auditing procedures. However, if the auditor can design highly effective analytical procedures, it may be possible to reduce the extent of detail testing needed even in areas of higher risk. The effectiveness of analytical procedures in reducing detection risk in comparison with the effectiveness of tests of details generally depends on the evaluation of the considerations listed later in this lesson. The following general observations are useful in evaluating the suitability of using substantive analytical procedures given the nature of the assertion to which the procedures are directed:

a. Analytical procedures are generally not effective in testing assertions about rights or obligations or assertions related to presentation and disclosure because those assertions do not lend themselves to testing through comparisons with expectations. For example, analytical procedures would not be effective responses for risks related to matters such as parties to transactions lacking in economic substance or intentional ambiguity in financial statement disclosures.

b. Relationships involving transactions over a period of time (that is, operating statement accounts) tend to be more predictable than relationships at a point in time (that is, financial position statement accounts). Because of the difficulty in developing expectations about a balance at a point in time with sufficient precision, analytical procedures are often not as effective as tests of details for assertions about the existence of assets and liabilities. For example, analytical procedures would not be as effective as tests of details when responding to such risks as potentially recording false receivables.

c. Analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses/expenditures. When testing for completeness, misstatements would often not be apparent from inspecting detailed evidence in the accounting records. For example, the analytical procedure of estimating property taxes by multiplying reliable data on total assessed valuation by the established tax rate is equally or more effective than inspecting supporting documentation for a sample of taxpayers.

d. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of revenues. For example, comparing recorded water revenue with the amount expected, based on a reliable record of number of gallons pumped and average rate per gallon, may be as likely to detect a material misstatement of assertions about the occurrence of revenues as inspecting supporting documentation for a sample of recorded revenue. Analytical procedures are more reliable if they are based on reliable data produced outside the accounting system (for example, operating data used to manage the entity).

e. Analytical procedures are often equally or more effective than tests of details for assertions about the occurrence of certain expenses/expenditures. For example, comparing recorded labor costs with the amount expected, based on the number of people required for the volume of activity during the year, may be as likely to detect a material misstatement resulting from errors as a detailed inspection of supporting documentation for a sample of recorded compensation expense. However, if fraud is a concern, analytical procedures may not be effective. For example, if management is able to manipulate expense accounts so that ratios appear reasonable, ratio analysis would not be an effective analytical procedure for detecting material misstatements.

f. Analytical procedures may be as effective as tests of details for assertions about the valuation of some assets and liabilities but not for others. Generally, whether an analytical procedure is as effective as a test of details for a valuation assertion depends on whether an expectation can be developed. For example, an analytical procedure may be as effective as a test of details for assertions about the valuation of service accounts receivable that are made up of a large number of relatively small balances. However, a test of details may be more effective when some account balances are disproportionately large. In that situation, failure to record an allowance for uncollectible amounts resulting from a deterioration in the financial condition of one of those customers either before or after year-end would most likely not be detected by an analytical procedure.

g. Substantive tests of details may be more effective for valuation assertions in an unstable environment. The ability to develop an expectation that approximates the recorded amount is greater when the environment is stable. For example, when interest rates are fluctuating widely, it is difficult to develop a precise expectation about interest expense. Similarly, when transactions involve management discretion, such as the choice of repairing versus replacing existing assets, there is also less predictability in expected relationships.

Confirmations. AU-C 505B, *External Confirmations*, and AU-C 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, provide guidance on several matters relating to audit confirmations. Matters covered by AU-C 505B and AU-C 330B include:

- External confirmation procedures.
- Use of negative confirmations.
- Factors affecting the reliability of confirmations.
- Management's refusal to allow external confirmations.
- Alternative procedures.
- Evaluation of confirmation results.
- Use of nontraditional confirmations.

AU-C 505B.06 defines an *external confirmation* as a direct response to the auditor from a third party either in paper form or by electronic or other means, such as through the auditor's direct access to information held by a third party. The types of confirmations used varies depending on the government's situation and the nature of its operations. Typically, positive, negative, and blank confirmations are the forms of confirmations used. Positive confirmation procedures are typically used to provide audit evidence for the existence assertion for asset and liability accounts.

Electronic Confirmations. Auditors often use electronic confirmations rather than a mailed, written communication. Electronic confirmations may be in the form of an email submitted directly to the respondent by the auditor or a request submitted through a designated third-party provider like Confirmation. Confirmation is a secure, online platform at **www.confirmation.com** for auditors to submit confirmation requests for cash, accounts receivable, accounts payable, employee benefits plan, and legal confirmations.

Some financial institutions no longer respond to paper confirmation requests. Instead, they respond only to electronic confirmation requests submitted via Confirmation. Validated financial institutions, considered "in-network," will respond to requests directly through the platform by confirming the requested information, requesting more information from the auditor, or denying the request. Confirmation has over 4,000 financial institutions in-network and also provides electronic and paper-based confirmation services for out-of-network responding parties.

Electronic confirmations can be considered reliable audit evidence. With traditional confirmations, AU-C 505B.A13 indicates auditors need to consider the following risks to the reliability of such information:

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

However, with Confirmation, auditors can guarantee from in-network responders:

- Response is from an authentic source.
- Responder has been validated and will be certified and knowledgeable about the information.
- Fraud will not occur during the confirmation process, as Confirmation is ISO 27001 certified.

Confirmation's online platform can be considered a sufficient, valid confirmation response if the auditor is satisfied that the electronic confirmation process is secure and properly controlled. In determining whether Confirmation's platform is secure, the auditor might review the ISO 27001 certificate, TRUST ecertificate, or the SOC examinations all found by visiting the website **www.confirmation.com**. Typically, the auditor would determine if the reports address the three risks noted above. If not, the auditor may perform additional procedures to address those risks such as reviewing Confirmation's Help Center or contacting the Support Team at 1 (866) 325-7201.

SELF-STUDY QUIZ

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

17. Which of the following substantive procedures is required in every audit to address management override of controls?

    a. Agreeing or reconciling the financial statements and accompanying notes to underlying accounting records.

    b. Evaluating the business purpose for all transactions, regardless of dollar amounts and frequency.

    c. Examine material journal entries and other adjustments made when the financial statements were prepared.

    d. Reviewing accounting estimates for any biases that might result in material misstatement due to fraud.

18. Typically, audit evidence is more reliable under what circumstances?

    a. It is obtained from sources within the entity being audited.

    b. The controls imposed by the entity over internally generated evidence are effective.

    c. The auditor obtains the audit evidence indirectly.

    d. It is available in the form of photocopies or electronic images.

SELF-STUDY ANSWERS

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

17. Which of the following substantive procedures is required in every audit to address management override of controls? **(Page 264)**

    a. Agreeing or reconciling the financial statements and accompanying notes to underlying accounting records. [This answer is incorrect. AU-C 330B.21 requires auditors perform this substantive procedure in every audit in relation to financial close and the reporting process. It is not required in relation to management override of controls.]

    b. Evaluating the business purpose for all transactions, regardless of dollar amounts and frequency. [This answer is incorrect. According to AU-C 240.32, as amended, it is required that auditors evaluate the business purpose (or lack thereof) of significant unusual transactions. It is not required that they do this for every transaction.]

    c. Examine material journal entries and other adjustments made when the financial statements were prepared. [This answer is incorrect. Per AU-C 330B.21, auditors are required to examining material journal entries and other adjustments made during the course of preparing the financial statements. This is a required substantive procedure for all audits in relation to the financial close and reporting process. This procedure is not performed specifically in relation to management override of controls.]

    d. **Reviewing accounting estimates for any biases that might result in material misstatement due to fraud. [This answer is correct. AU-C 240.32, as amended by SAS No. 135, requires certain substantive procedures in all audits to address the risk of management override of controls. One of these required procedures is for the auditor to review accounting estimates for biases that could result in material misstatement due to fraud including (1) evaluating whether management's judgments and decisions, even if they are individually reasonable, indicate possible bias that may represent a material misstatement due to fraud and, if so, reevaluating the accounting estimates as a whole and (2) performing a retrospective review of management's judgments and assumptions related to significant prior-year accounting estimates.]**

18. Typically, audit evidence is more reliable under what circumstances? **(Page 266)**

    a. It is obtained from sources within the entity being audited. [This answer is incorrect. Per AU-C 500B.A32, audit evidence is more reliable when it is obtained from knowledgeable independent sources *outside* the entity.]

    b. **The controls imposed by the entity over internally generated evidence are effective. [This answer is correct. An important quality of audit evidence is its reliability, which is affected by both the nature and source of the evidence. AU-C 500B.A32 provides certain generalizations about the reliability of audit evidence, including that audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.]**

    c. The auditor obtains the audit evidence indirectly. [This answer is incorrect. As discussed in AU-C 500B.A32, audit evidence obtained *directly* by the auditor (e.g., observation of the physical evidence of inventory stored at a third-party warehouse) is more reliable than audit evidence obtained indirectly or by inference (e.g., confirmation with the custodian).]

    d. It is available in the form of photocopies or electronic images. [This answer is incorrect. Audit evidence provided by *original documents,* as discussed in AU-C 500B.A32, is more reliable than audit evidence provided by photocopies, faxes, or electronic images.]

CONSIDERATIONS FOR TESTS OF DETAILS

Tests of details may be applied to transactions or to balances. Those tests can be described as follows:

a. *Tests of Transactions.* These are tests of individual transactions by obtaining supporting evidence of the transaction, such as inspection of the documents and accounting records involved in processing, e.g., inspecting supporting documents for a cash disbursement.

b. *Tests of Balances.* These are tests applied directly to the details of balances in general ledger accounts, e.g., confirming the balances of accounts in the service accounts receivable subsidiary ledger with individual customers.

Tests of transactions and tests of balances are related because each class of transactions affects a related account balance. For example, purchase transactions affect the accounts payable balance. An auditor may test the transactions that enter an account balance, the individual items included in the ending balance, or both. Generally, tests of balances are more efficient and effective than tests of transactions because transaction tests are applied to individual transactions and may be more time-consuming than direct tests of a balance that results from many transactions.

Specialized Considerations for Governmental Units

In a governmental engagement, transaction testing is relatively more important than tests of balances. In contrast to small businesses, a small local government typically has a high volume of transactions and relatively small related account balances. Further, that large volume of transactions is subject to a large variety of compliance requirements that include both legal and contractual considerations.

Generally, there are two broad categories of transactions that should be tested—revenues and expenditures. The major classes of transactions within the revenue category need to be identified to develop audit programs. The major classes will vary depending on the governmental unit. For most governmental units, property taxes will be a major class of transactions. Other major classes may include licenses and fees, special assessments, fines, grants or shared revenues, interfund transfers, and bond proceeds. Generally, it is necessary to specify audit objectives and select appropriate procedures to achieve those objectives for each major class of revenue transaction.

The major classes of expenditure transactions also need to be identified. For most governmental units, major classes will include personal services (salaries, wages, and benefits), goods and other services, and capital expenditures. In specific circumstances, other major classes of transactions in the expenditure category may be important; e.g., indirect cost allocations.

Because of the relative importance of transaction testing in a governmental engagement, the auditor will ordinarily use some audit programs that are directed primarily to a transaction class rather than the related financial position statement account balances. In contrast, in a small business engagement, the primary focus is usually on financial position statement (balance sheet) accounts. The common areas in a governmental engagement where the focus is primarily on transactions are as follows:

- Revenue, receivables, and receipts for governmental funds.
- Expenditures for goods and services and accounts payable.
- Payroll (salaries, wages, and benefits) and related liabilities.

Also, there are other areas in a governmental engagement that are concerned with both statement of net position account balances and transaction classes. The primary examples are as follows:

- Capital assets and capital expenditures.
- Debt and debt service expenditures.

Generally, the statement of net position amounts are presented in the government-wide financial statements and in the reconciliation to the funds statements. However, the related expenditures are presented as current expenditures of governmental funds. Thus, the auditor has to be concerned with both the statement of net position accounts and the transaction classes.

Confusion about Tests of Details of Transactions

Inspection of documents and accounting records may be involved in both tests of controls directed toward operating effectiveness (if controls leave a documentary trail) and tests of details of transactions. For this reason, some auditors have equated tests of details of transactions and tests of controls. The difference is in the objective of the test and the nature of any exceptions. The mere fact that a transaction rather than a balance is being tested does not make an audit procedure a test of controls. For example, the inspection of invoices in support of additions to capital assets is a *substantive* procedure. The objective of the test is to substantiate the balance of the capital asset account by testing the transactions, i.e., the additions. The same principle applies to other types of transactions or balances. For example, service revenue transactions may be tested to substantiate total revenue without testing the effectiveness of control policies and procedures for processing individual transactions. The objective of the test, and not whether it is applied to a class of transactions or a balance, determines whether the test is a test of controls or a substantive procedure. Additionally, exceptions when performing tests of details of transactions or balances are monetary in nature and result in a misstatement in terms of dollars. Material exceptions generate a proposed audit adjustment entry. In contrast, exceptions when performing tests of controls are measured as rate of noncompliance with the control procedure. When the rate of exceptions is too high, the control is not effective. The auditor's assessment of control risk would be changed and the auditor would determine an appropriate response to the modified risk assessment. Substantive procedures, including tests of details of transactions, are normally applied after the auditor has obtained an understanding of internal control, but substantive tests of details of transactions in the current period may contribute to the auditor's understanding of controls in subsequent periods. Tests of details of transactions can be performed concurrently with tests of controls.

Selecting Items for Testing

AU-C 330.A66, as amended by SAS No. 135, notes that an important consideration in the effectiveness of tests of details and appropriateness of audit evidence is selecting the items to test. Items need to be selected in a way that is effective in meeting the purpose of the test. Alternatives in selection of items to test include—

- *Selecting All Items.* Generally an entire population is selected when either the population contains a small number of large value items or a significant risk exists and other means do not provide sufficient appropriate audit evidence.
- *Selecting Specific or Individually Significant items.*
- *Audit Sampling.*

Auditors may use one or a combination of those alternatives in selecting items for testing. Considerations for the method used include efficiency and the risks of material misstatement related to the account or transaction being tested. More detailed information about audit sampling and selecting specific or individually significant items, while outside the scope of this course, is available in *PPC's Guide to Audits of Local Governments*.

Required Documentation

For substantive tests of details, AU-C 230B, *Audit Documentation*, requires documentation to include identifying characteristics of the items tested. The authors believe items tested can be identified by listing the items; by including a detail schedule in the workpapers, such as an aged trial balance, on which the items are identified; or by documenting in the workpapers the source and selection criteria.

CONSIDERATIONS FOR SUBSTANTIVE ANALYTICAL PROCEDURES

Types and Purposes of Analytical Procedures

What Are Analytical Procedures? Analytical procedures are evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data. Analytical procedures include trend analysis, ratio analysis, and predictive or reasonableness tests. Using analytical procedures generally involves—

a. developing an expectation of what an account balance should be,

b. comparing the expected amount with the recorded amount,

c. determining whether any difference between the recorded and expected amount is significant,

d. investigating the cause of any unexpected significant difference,

e. evaluating the likelihood of material misstatement, and

f. documenting the analytical procedures.

As indicated by items a. and b., analytical procedures involve comparisons of recorded amounts, or ratios of recorded amounts, to expectations developed by the auditor. These expectations can be developed from a variety of sources of financial and nonfinancial information, but the most important aspect of developing expectations is having a thorough knowledge and understanding of the client and its industry and the risks the client faces.

Analytical procedures may consist of simple comparisons or complex models. For example, the following are analytical procedures:

a. Comparison of an account balance with the balance of the prior period or with a budgeted amount.

b. Computation of the ratio of one financial statement account balance to the balance in another account with which it would be expected to have a predictable relationship, such as computation of the ratio of interest expense to debt and comparison of the resulting ratio to the known interest rate on the debt.

c. Estimation of investment income by considering the amount invested and the average earnings rate.

Most explanations of analytical procedures focus on the steps involved in comparing the recorded amount to the expectation, but the authors prefer to think of analytical procedures as a coordinated family of procedures that include scanning and inquiry as well as computations and comparisons. Scanning accounting records to identify unusual or unexpected relationships, or the absence of expected relationships, is an integral aspect of applying analytical procedures. What account balances have increased significantly since the prior year? Are there new accounts? Inquiry is also a critical companion procedure in all aspects of applying analytical procedures. Inquiry procedures are a crucial part of the process of identifying all of the following: useful analytical procedures, worthwhile sources of information for developing expectations, and explanations for differences between recorded amounts and expectations.

Purposes of Analytical Procedures. AU-C 315B and AU-C 520B identify the following three categories of analytical procedures based on the purpose of the procedures:

- *Preliminary (Planning) Analytical Procedures.* Used to enhance the auditor's understanding of the governmental unit and assist in assessing areas of specific risk of misstatement by identifying unexpected relationships among account balances or the absence of expected relationships (AU-C 315B.06 and AU-C 315B.A14).

- *Substantive Analytical Procedures.* Used to obtain audit evidence about potential misstatements (AU-C 520B.05).

- *Overall Review Analytical Procedures.* Used in the final review stage of the audit (AU-C 520B.06).

Both preliminary and overall review analytical procedures are required in an audit of financial statements, but use of substantive analytical procedures is discretionary. Preliminary analytical procedures are an important step in audit planning and risk assessment. Overall review analytical procedures are part of the final review of the financial statements to assure that the numbers make sense. This final step in the audit is made to be sure the auditor has obtained a sufficient understanding of the financial statements during the audit. Substantive analytical procedures are explained in this section. Though outside the scope of this course, more information about preliminary and overall review analytical procedures can be found in *PPC's Guide to Audits of Local Governments*.

What Distinguishes Substantive Analytical Procedures? The purpose of analytical procedures and the level of assurance desired are what distinguish substantive analytical procedures from preliminary and overall review analytical procedures. No particular types of analytical procedures are exclusively substantive procedures. The same procedures, ratios, or relationships might be used for more than one of the three purposes of analytical procedures. For example, the auditor might use an analytical comparison of expenditure/expense to budget at all three stages of the audit. However, those analytical procedures would more likely be applied at a more detailed level—by function, department, or program—as a substantive procedure.

Substantive analytical procedures are focused on particular account balances and relevant assertions, and the auditor will have already assessed the risk of misstatement of the relevant assertion, including the likely direction of the misstatement. The auditor will have decided that the performance of analytical procedures alone or in combination with tests of details is likely to provide reasonable assurance that the account balance is not materially misstated in relation to the overall financial statements. To accomplish this, the auditor will have concluded that a sufficiently precise expectation of the recorded amount being tested can be developed from reliable financial or nonfinancial data.

Substantive analytical procedures will either be the primary test of the account balance or will be used in combination with tests of details. Essential features of substantive analytical procedures are developing expectations by identifying plausibly related and reliable data, and identifying whether there are differences from those expectations that require investigation. If the differences from expectations are sufficiently small, the auditor can conclude that there is reasonable assurance the account balance is not misstated. Larger differences have to be investigated by obtaining and corroborating explanations.

How to Design Effective Substantive Analytical Procedures

Analytical procedures have been described as a natural extension of the process of understanding the client's business. Substantive analytical procedures are a focused way of translating this understanding into reasonable assurance that a particular account balance is not materially misstated.

According to AU-C 520B.05, when designing substantive analytical procedures, the auditor should consider whether:

- The use of substantive analytical procedures is appropriate considering the relevant assertions.
- The data from which the expectation of recorded amounts or ratios is developed is reliable.
- The expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance.
- The amount of any difference in recorded amounts from expected values is acceptable.

Exhibit 3-2 provides factors that affect the expected effectiveness of an analytical procedure. Certain of these factors are discussed in the following paragraphs and later in this lesson beginning in the "Predictability of the Relationship" paragraph. The discussion in this section provides practical advice on designing effective analytical procedures tailored to the client's circumstances.

Exhibit 3-2

Factors Affecting the Expected Effectiveness of an Analytical Procedure

- *Nature of the Account.* Statement of revenues and expenditures/expenses accounts are generally more favorable to the use of analytical procedures as substantive procedures than are financial statement position accounts. Also, substantive analytical procedures generally are more effective for accounts that have a large volume of transactions that are predictable over time.

- *Nature of the Assertion Being Tested.* Analytical procedures can be more effective than tests of details for testing the completeness assertion.

- *Likely Cause of Potential Misstatement.* Analytical procedures tend to be more effective when the risk of misstatement is assessed as being primarily from error rather than from fraud.

- *Degree of Relationship among the Data to Which the Analytical Procedure Is Applied.* Analytical procedures are more effective when there is a close relationship between the account and the data used to predict the balance.

- *The Stability of the Client Environment.* Analytical procedures are generally more effective in a stable environment.

- *Existence of Offsetting Factors that Affect the Amount Being Tested.* Analytical procedures are generally more effective when offsetting factors are taken into consideration (for example, when the mix of services provided affects total revenues).

- *The Source and Reliability of Data Used in the Procedure.* Examples of reliable data include internal financial information from comparable prior periods, budgets, extrapolations from interim or annual data, or data developed under a reliable system with adequate controls; internal nonfinancial or operating data from sources independent of those responsible for the amount being audited; and external industry statistics or comparable entity data.

- *The Level of Detail Used to Develop the Expectation.* For instance, a more effective test generally results from use of monthly rather than annual data, or data by department rather than entity-wide data.

First Ask the Government's Management. A productive initial step in designing effective substantive analytical procedures is to first ask management what ratios, relationships, and internal or external data management finds particularly useful, particularly in identifying and monitoring risks. This also helps the auditor to get a better feeling for how the government really works. What are the key factors that management monitors to stay on top of operations? Are there industry or trade publications that provide particularly useful information? Do any published statistics on the economy or the industry help management to be aware of important trends or patterns? In some cases, management may have prepared reports with ratio analyses and comparisons the auditor can use. The auditor ordinarily gains this knowledge from management while performing risk assessment procedures.

Governmental units are often very sensitive to political, demographic, and economic changes. There may be a taxpayer initiative to limit or restrict certain types of taxes, or a new administration may promise to reduce taxes. Factors such as unemployment rates, age and income demographics of the population, assessed values of real property, population trends, and local commercial economic indicators, such as retail sales, may influence the level and type of governmental activities. Unfavorable economic conditions may cause a reduction of grant funding from government funding sources. Governmental units may also experience revenue shortfalls due to losses on investment portfolios caused by market declines or lower investment returns caused by lower interest rates.

The response of the particular governmental unit to external forces may vary considerably depending on the internal administrative and operating characteristics. Some governmental units may cut costs and reduce or eliminate various services or programs. Others may attempt to develop new revenue sources or engage in aggressive investment strategies. These responses can affect key audit areas as well as the risk of particular types of misstatements. The need to economize may lead to the elimination or weakening of existing controls that will increase the risk of material misstatement. The auditor should discuss with management the external forces and other conditions that could affect the audit.

Consider the Government's Budgetary Process. In preparing a budget, management has to evaluate the key factors that affect future operations and the relationships among these factors. Management has to identify relationships among financial statement amounts and other financial and nonfinancial data to establish a reliable budget. The auditor may inquire of management and personnel who develop the budget about what relationships are known to be effective predictors.

The budget data can be a good source of auditor expectations. For example, the auditor can use the budgeted amount for an account balance as the auditor's expectation of the recorded amount. However, the auditor may want to consider using the *original* budget to determine variances from actual. The auditor can then determine why actual amounts changed from the original estimate, especially if the entity amends the budget to mirror actual activity. As a minimum, the inquiries about budget preparation and inspection of budgets and variance reports provide the auditor with a good working knowledge of the key factors that affect particular account balances and the stability of plausible relationships. For example: How closely do capital asset additions track the budget? What operating data are most useful for predicting expense levels? The auditor could use such information in deciding what ratios to compute or predictive tests to design.

Most governmental units are subject to budget and appropriation laws, which are established by statutes, constitutional provisions, etc. Thus, once adopted or appropriated, budgets and appropriations usually have the force of law. The budget adoption process is highly political because the budget determines the allocation of resources to various programs. That is, the budget that the legislative authority adopts and the resources it appropriates determine the degree to which approved programs will be funded. For example, budgets and appropriations often specify that particular funds finance particular costs and establish the nature and amount of interfund activity. The budget and appropriations allocate anticipated resources and, normally, expenditures can exceed budgeted amounts only after additional action by the legislative authority. Because the adopted budget is so important, governmental accounting systems and financial reporting are designed to facilitate and demonstrate adherence to the budget. For example, either the basic financial statements or required supplementary information must include an analysis of significant budget variances (original versus final budget and final budget versus actual results) for the general fund and each major special revenue fund with a legally adopted budget.

Based on inquiry, observation, and reading of relevant statutes and ordinances, the auditor should obtain an understanding of and document a general description of the budgeting procedures. The auditor should obtain an understanding of the process for adopting and amending budgets, controlling expenditures, and monitoring adherence to budgets. For example, the auditor could ask management whether department heads are required to address budget variances on a monthly, quarterly, or annual basis or not at all. The existence of such controls may enforce accountability over expenditures as compared to the approved budget allowing the auditor to limit audit procedures to inquiry and substantive analytical review.

The authors recommend that, in a governmental engagement, audit procedures include comparison of account balances in the working trial balances to similar amounts in the current period's budget. However, a thoughtful consideration of expected relationships among account balances and periods by an experienced auditor is more important than a mechanical comparison. The auditor considers these relationships and what other knowledge they contribute about the governmental unit and government operations.

Identify Government Comparables. For years, there have been suggestions that auditors consider making greater use of industry statistics as a source of data for comparisons in performing analytical procedures. These comparisons provide insight on how the client's performance compares to that of similar entities. A significant variation from a similar entity indicates a risk of potential misstatement and warrants being investigated.

Making comparisons among general purpose governments may be difficult because they engage in such a variety of activities and are so affected by political factors. However, it may be meaningful to compare segments of a general government, such as proprietary funds that provide water, sewer, or garbage service, with similar sized governmental or commercial entities. It may also be meaningful to make comparisons among similarly sized and located specialized entities such as school districts. Also, the auditor may be able to make a meaningful comparison with another general purpose government of similar size, geographic location, demographic makeup, and type of administration. Once the auditor has identified such a comparable, it can be easy to obtain the governmental unit's financial statements because they usually are a matter of public record. Many, if not most, governments publish their financial statements online. Other possible sources of information for comparisons include the following:

- *Comprehensive Annual Financial Report.* GASBS No. 34 recommends that governments publish a Comprehensive Annual Financial Report (CAFR). A CAFR contains statistical information that reflects social and economic data, financial trends, and the government's fiscal capacity, and may be used to make comparisons.

- *Performance Measures.* Some governments use performance measurement (also called service efforts and accomplishment or benchmarking) to monitor the effectiveness and efficiency of their programs, and such measures may provide a basis for comparison. The International City/County Management Association (ICMA) publishes numerous reports on performance measurement. ICMA reports and other performance measurement information is available at **www.icma.org**.

Auditors of governmental units that belong to associations such as the Government Finance Officers Association (GFOA) or International City/County Management Association (ICMA) might have access to the financial trend information accumulated by the association about the other members.

The auditor may attempt to find a few governmental units (or even just one) that are comparable to the client. The auditor can do this by asking management to identify one or more governmental units that are comparable to the client. The auditor might then obtain information from that government or its financial statements, which, as previously mentioned, typically are available online.

In addition, other governmental units that are clients of the auditor's firm also can be a valuable source of statistical information for use in developing expectations. Auditors who work mainly with governmental units might have two or more clients with similar operations and activities. In addition to providing information with which to develop expectations, the results of comparing similar governmental units may be combined and distributed to the governmental units. The information is to be combined and distributed with the clients' permission and typically aggregated and displayed in such a manner that one client does not have access to another client's nonpublic financial information.

The insight provided by comparing the client's financial statements to those of a comparable governmental unit can be very useful and worthwhile.

The auditor could also develop a set of ratios and analysis of historical financial information of the client that could be used to analyze financial trends. For example, comparing revenue by source for the past five years improves understanding of the governmental unit's activities and may identify a revenue source that requires increased attention in the current audit.

Talk to the Government's Operating Personnel. The auditor needs to go outside the accounting department and talk to other than financial management personnel when designing and performing analytical procedures. Discussions with operating management and personnel can be invaluable in learning enough about the client's operations and risks to design effective analytical procedures.

Generally, operating departments can be a source of reliable data outside the influence of accounting personnel who record transactions related to those operating functions. The auditor considers whether the data in the operating department is independent of the accounting department. The auditor also considers whether the preparation of the operating data is subject to manipulation by senior management in a manner that would permit management to alter both the operating and related accounting data.

For example, assume the government provides residential customers with garbage pick-up service and also owns a municipal golf course. The auditor could interview the sanitation department's operations manager and the golf course's director of development or community affairs to better understand how the respective budgets are developed. The auditor could also determine whether there is reliable data developed and maintained in those departments that could be used in developing a reliable expectation for garbage fund and golf course revenue and expenses. The auditor might ask about the number of households that receive garbage service or the number of visitors to the golf course and the average fees charged. The auditor might also ask about any special golfing events or tournaments and related costs and revenues. Discussions with the operating personnel enhance the auditor's understanding of the significant transactions and events that have affected the financial statements and might corroborate the auditor's risk-assessment conclusions. The enhanced understanding can lead to improvements in the development of expectations of recorded amounts as well as a more insightful evaluation of differences from those expectations.

Consider Whether Circumstances Are Favorable to Substantive Analytical Procedures

Predictability of the Relationship. Certain circumstances are favorable to the use of substantive analytical procedures as the primary, or an important, source of assurance on an account balance. Some account balances or assertions lend themselves to use of substantive analytical procedures. Erroneous conclusions may result if analytical procedures are applied to data that appear to be related but really are not. Generally, relationships among revenue and expenditure/expense account balances, or revenue and expenditure/expense and certain financial position statement account balances are more predictable than relationships only among financial position statement items. Many governmental units are well suited to the application of analytical procedures, particularly in the areas of governmental fund revenue, proprietary fund service revenue, payroll and employee benefits, and debt service expenditures.

Likely Cause of Potential Misstatements. Substantive analytical procedures tend to be more useful as the primary substantive procedure when the risk of misstatement has been assessed as being primarily from error. This is because errors by nature are as likely to be understatements as overstatements. Generally, a substantive analytical procedure is effective for simultaneously testing for both overstatements and understatements. Tests of details tend to be directed to either overstatement or understatement. For example, a predictive test of revenue developed from operating data can be effective for detecting either overstatement or understatement of recorded revenue. In contrast, tests of details are usually focused on a single direction. Detection of understatement, for example, is the focus of tracing from records of service provided to recorded service revenue, while overstatement of revenue is more likely to be detected by inspecting supporting documents or confirming balances. Also, errors are unintentional; therefore, no one is attempting to conceal them. This does not mean, however, that analytical procedures are useless as tools in fraud detection. Analytical procedures are an important aid in detecting fraud. Use of analytical procedures when the general risk analysis indicates a greater risk of fraud is explained later in this section.

Availability of Reliable Data. Because substantive analytical procedures involve developing an expectation of a recorded amount based on a plausible relationship between that amount and other financial or nonfinancial data, another circumstance that favors use of these procedures is the availability of reliable data to develop expectations. Generally, data obtained from an independent outside source are better than internal data. Nonfinancial data from an independent operating department tend to be more reliable than data under the influence and control of the accounting department when there are effective controls over collection of the operating data. Data from the accounting department are more reliable when controls over the accounting system are effective. Audited data are more reliable than unaudited data. The data might be audited by the auditor or by internal auditors judged to be objective and competent. Generally, the auditor exercises professional skepticism in evaluating the reliability of available data and seeks more reliable data to achieve greater precision.

For a governmental unit, property tax revenue provides an excellent example of an area for which analytical tests are very effective because relatively accurate predictive tests can be made. Property taxes can be relatively easy to estimate because the factors involved (that is, assessed valuation and tax rate) are usually known. Fluctuations from period to period may be small or explainable based on known changes; for example, tax rate change. Property taxes can usually be substantiated in total by analytical computation. Often, maintenance of the tax roll and determination of the assessed valuation are the responsibilities of another governmental unit; for example, a county appraiser. In that case, the information may be obtained directly from the other governmental unit. After obtaining reliable information on assessed valuation, all the auditor needs to do is examine the ordinance establishing the tax rates or confirm the rates; compute the tax levy; decrease the tax levy by the historical collection rate; and compare it to the recorded property tax revenue.

For service revenue and receivables, analytical tests that provide persuasive audit evidence on the validity and completeness can often be designed. Total service revenue can be computed by multiplying quantity of service provided during the period by the average rate; for example, gallons of water pumped or purchased times the average rate per gallon. Often, engineering or production reports are available that provide reliable data on quantity of service provided; for example, an engineering record of water pumped adjusted for estimated leakage, evaporation, and faulty meters.

Precision of Expectation. Another related consideration is whether the expectation can be developed with reasonable precision. *Precision* is the term used to describe the expected degree of accuracy of the prediction of the amount or the account balance developed by the auditor. The auditor's expectation becomes more precise as the range of expected differences between the prediction and the true amount of the account balance narrows. For example, investment income is more predictable when the returns on investments held can be obtained from publicly available sources or when the mix of investments does not change significantly during the period. When an auditor is combining the evidence from substantive analytical procedures with evidence from tests of details, a less precise expectation may be appropriate. A more precise expectation may be necessary when the substantive analytical procedure is the only procedure planned to address a particular risk of material misstatement.

Other things remaining equal, the larger the recorded amount, the more difficult it is to develop a precise expectation. This is because a small percentage of a very large recorded amount can be material to the financial statements taken as a whole. For example, the planning materiality amount calculated using total revenue as the benchmark might range from 0.5% to 2% of total revenue, and performance materiality would be less than planning materiality. This means that an expectation developed of recorded total annual revenue would need to be within less than 2% of the recorded amount to be used as the primary substantive test of total annual revenue without additional evidence. In some cases, the data might be reliable enough to develop such a precise expectation; but, in other cases, the auditor might need to break the recorded amount down into more predictable components. Expectations developed at a more detailed level have a greater chance of detecting a misstatement of a given amount. For example, expectations developed concerning monthly amounts are generally more precise than annual amounts. Comparisons by location or department are generally more precise than entity-wide comparisons. Sometimes, an account balance can be separated into different categories of transactions.

In testing a governmental unit's payroll, the auditor often can use effective analytical tests and efficient tests of payroll totals. An analytical test that often produces persuasive evidence is to compare payroll expenditures to the prior-period actual and current budget (by department or function and in total) and relate it to the number of personnel (by department or function and in total).

Analytical tests are also often effective for employee benefits, including compensated absences. For example, the auditor can compare vacation and sick leave amounts to the prior-period actual and the current budget and can compare the ratio of amounts to gross pay with the ratio for the prior period. The relation of these and other employee benefit expenditures (such as pension expenditures) to the number of covered employees can be compared to the same relationship in the prior period.

To analytically test a governmental unit's debt service expenditures or expenses, the auditor can often obtain persuasive evidence on the reasonableness of interest expenditures by comparing the amount to the computation of average rate times average debt outstanding. Normally, a schedule of debt service is prepared by the governmental unit and the auditor can review the schedule for reasonableness in conjunction with analytically testing interest cost.

Efficiency. Another consideration that affects an approach of primarily substantive analytical procedures is the relative efficiency of tests of details for the account balance. Other things remaining equal, an account balance composed of a small number of large items can be tested as efficiently and more effectively using tests of details. If an account balance has a large number of small items, efficiency can usually be improved by using substantive analytical procedures to test the total recorded amount. Analytical procedures are also more efficient and effective when the relationship between available data has proven to be relatively predictable and stable in the past. For example, the precision of analytical procedures using trend analysis and ratio analysis is improved when the underlying relationships are known to be reasonably predictable and the business environment is relatively stable.

Using Computer Software to Help Perform the Analytical Procedures

Analytical procedures can often be designed using trial balance or spreadsheet software. For example—

a. Changes in amounts or relationships between amounts over two or more periods can be calculated using either the report features of trial balance software or worksheets designed for the engagement by the auditor using spreadsheet software such as Microsoft Excel.

b. Regression analyses of relationships between results for two or more periods can be performed using the regression analysis feature in Excel.

Audit Data Analytics (ADA). ADA can also be used to assist in performing analytical procedures. ADA allows the practitioner to analyze information downloaded from a client's computer system. Procedures such as calculating and sorting percentage variances in accounts between periods and calculating financial ratios can be performed using ADA. In addition, those procedures can be performed at a detailed level as easily as at an aggregated level, resulting in a higher level of precision.

Because most clients maintain much of their financial information electronically, ADA is a common and important tool. It can be especially important in situations in which the client maintains very large data files or processes substantially all of its activities electronically.

Analytical Procedures and Fraud Detection

An important factor behind the decision by auditing standards setters to require analytical procedures in all audits of financial statements was research that indicated that use of analytical procedures was a frequent factor leading to detection of fraudulent financial reporting. Analytical procedures are required in the planning stage of the audit to make sure the auditor looks at the big picture first and recognizes areas for which fraud risk is greater. Likewise, professional standards require analytical procedures in the final review stage of the audit to make sure the auditor looks at the financial statements in total at the end to see that they make sense based on the auditor's understanding of the governmental unit and its environment obtained during the audit. More detailed preliminary analytical procedures or substantive analytical procedures used during the audit can also be helpful in detecting fraudulent financial reporting. AU-C 240B.34 requires that the auditor evaluate whether analytical procedures performed as substantive procedures or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. For example, significant and unusual relationships related to year-end revenue, such as unusually large amounts of revenue or gains near the end of the reporting period from unusual transactions, might be indicative of fraud. Additional examples of such unusual or unexpected relationships are as follows:

- Revenues are significantly different from originally budgeted revenues or from prior period actual revenues without corresponding changes in the revenue base or rates.
- A significant increase in revenue over the prior period is just enough to prevent having to report a violation of debt covenants or a deficit in an equity account.
- There are large miscellaneous or one-time revenues.
- There is revenue from the sale of assets but no corresponding reduction in asset accounts.
- Deferred amounts are significantly different from those in the prior period.
- Investment income results are contrary to market conditions.
- Revenue from cost reimbursement grants is not supported by the amount of grant expenditures.

Also, the auditor should investigate responses to inquiries about analytical relationships that have been vague, implausible, or inconsistent with the auditor's knowledge or other audit evidence.

A word of caution on analytical procedures and fraud detection is necessary. Analytical procedures can be effective in identifying audit areas with an increased risk of fraudulent financial reporting, but the *absence* of significant fluctuations is not reliable evidence of the absence of a risk of material misstatement due to fraud. Management can manipulate recorded amounts to make relationships appear normal to conceal fraud.

Generally, analytical procedures are useful for identifying audit areas in which there is an increased risk of material misstatement from fraudulent financial reporting. Analytical procedures usually do not provide sufficient evidence to resolve whether a potential material misstatement is caused by fraud, but are efficient and effective for directing the auditor's attention to account balances and relevant assertions that require investigation of a potential fraud. In this area, particularly, it is important to recognize that there are no magic ratios or relationships that work for all clients. Also, a solid understanding of the client's operations is even more critical in designing effective analytical procedures in this area. The auditor cannot recognize unusual relationships, the absence of expected relationships, or other anomalies in the financial statements unless the auditor has a good sense of what the financial statements should look like in the client's circumstances. In other words, the auditor needs to know what is usual—what should be there—before the unusual can be recognized.

When there is a greater than normal risk of fraudulent financial reporting, finding at least one comparable entity for analytical comparisons as recommended earlier in this section can be extremely helpful and provide needed insight to what relationships are anomalous. By comparing the activity of the client to a comparable government, the auditor can more readily identify unexpected relationships or the absence of expected relationships as well as develop better expectations of recorded amounts.

Substantive analytical procedures focused on particular relevant assertions are useful in refining the assessment of the risk of misstatement from fraudulent financial reporting. When the primary risk is fraudulent financial reporting, the focus of analytical procedures is generally on the revenues and expenses that might be misstated. The particular analytical procedures have to be designed to fit the specialized circumstances of the client and its operations. For enterprise funds, comparisons of actual cash receipts and disbursements with recorded accrued amounts are generally useful in identifying what portion of the total recorded amount is dependent on a subjective estimate.

Ratios that compare cash flow related to a recorded amount to the total amount often provide a specific quantification of widely recognized plausible relationships. For example, generally there should be a pattern in the trend of revenue and receivables. A higher percentage increase in receivables than revenue is an unexpected relationship. A more specific quantification using this relationship is a computation of the portion of revenue recognized during the period that has been collected in cash.

Some auditors find that a useful way to get an overall perspective on the cash component of recorded accrual amounts is to compare revenue and expenditure/expense balances with the components of cash flow from operations calculated using the direct method. If recorded cash flow from operations is positive, but the entity experiences inexplicable cash shortages, that is a warning sign of misappropriation of assets. Generally, noncash amounts are easier to manipulate than actual cash flows. That is why quantification of the portion of a recorded amount that is noncash can be a useful measure of exposure.

Whether the assessed risk is of misappropriation of assets or fraudulent financial reporting, imaginative use of analytical procedures can be useful in refining the risk assessment for detecting the misstatement. If the auditor focuses on trends that are difficult or impossible to manipulate by the perpetrator, analytical procedures will generally be more effective. Volume data trends generally follow reported amounts. For a governmental unit, the auditor could analyze the number of service units provided by the governmental unit and compare that to the revenue associated with those service units. If service units are increasing, the auditor would anticipate that revenue would also increase. This same type of analysis could be performed for the following:

- The number of properties on the tax roll and property tax revenue.
- The number of businesses and franchise tax revenue.
- The number of households and amount of water, sewer, sanitation, or other utility service revenue.
- The number of licenses, fines, or bonds issued and related revenue.
- The number of admissions and admissions revenue.

By comparing the trends of operating volume measures to recorded amounts, the auditor can identify account balances with a risk of misstatement due to fraud. Generally, this approach is equally effective for either misappropriation of assets or fraudulent financial reporting. For example, if labor costs are increasing, but wage rates have not increased and the number of employees has not increased proportionately, there may be a payroll fraud involving a padded payroll ("ghost" employees) or duplicate payroll checks. On the other hand, a decrease in labor costs without a reduction in hours worked might be indicative of improper capitalization of direct labor. The preceding discussion focuses on fraud, but these types of comparisons may also be useful in detecting misstatements due to error.

Corroboration of Explanations. An important consideration related to fraud detection (as well as error detection) is the evaluation and corroboration of management's explanations for significant differences from the auditor's expectations. In this area, the main ingredients for effectiveness are healthy doses of common sense and professional skepticism. An attitude that includes a questioning mind and a critical assessment of audit evidence is necessary to exercise professional skepticism. The auditor ought to adopt a "show me" attitude and not accept explanations that conflict with the auditor's understanding of the client's circumstance.

For example, for a governmental unit that charges for water, sewer, sanitation services, or other utility services provided, recorded service revenue and direct and indirect expenses are linked in an operating cycle that results in plausible, persistent relationships. If service revenues from a particular service are increasing but related expenses are decreasing, the auditor questions why and regards the client's response skeptically. Management may explain a decrease in garbage collection costs as due to the replacement of old garbage trucks requiring a three-man crew with new automated trucks that require only a two-man crew, but the auditor does not accept the explanation at face value. The auditor could review the minutes of the governing board meeting authorizing the purchase of the new trucks and review the labor specifications related to the new trucks. The auditor may also review newspaper and other local media reports for the change in the garbage collection system and the expected labor cost reductions. The auditor may also determine that the related payroll costs have decreased proportionately to the labor reduction and that the capital expenditures reflect the purchase of the new trucks and retirement of the old ones.

Common sense combined with healthy professional skepticism and knowledge of the government are essential to recognizing that the financial statements have been misstated by fraud. In corroborating explanations, the auditor is wary when information that should be readily available is not supplied promptly. This is an important aspect of professional skepticism.

For example, if the auditor compares the current year's tax revenue from fines with that of prior years and notes an increase, the auditor carefully evaluates the reason for the increase. Management may explain that this year the police department had a special one-month campaign to target and ticket speed limit violations and cars running red lights in order to cut the number of traffic accidents. Management states that the campaign resulted in a significant increase in traffic tickets issued during that month and a corresponding revenue increase. However, when asked, management could not promptly produce information supporting a decision to conduct such a campaign or duty rosters showing a reallocation of police officers to targeted intersections. Additionally, management's explanations may be inconsistent with information from the police department on the number of traffic tickets issued during the period. That increases the auditor's suspicions, and the auditor needs to investigate further. The auditor needs to also be wary when explanations obtained from different sources conflict.

Analytical Procedures and Interim Testing

Audit efficiency and effectiveness can often be improved by shifting more audit work to interim dates. This can permit earlier identification of issues and problems and allow corrective action to be implemented before final work starts. Also, there are advantages to spreading out the audit work over a longer period of time. This makes it easier for client personnel because their time preparing for the audit is also spread out. Client personnel have more time to prepare schedules and answer questions. Also, because the audit work is spread out, the engagement team can usually be smaller. This not only has budget advantages, but the longer exposure to the client also can improve everyone's understanding of the client's operations.

When tests of details are performed at an interim date, the auditor generally needs to perform roll-forward procedures for the period between the interim date and the balance-sheet date. Analytical procedures are usually an important part of roll-forward procedures. Substantive tests performed prior to the balance-sheet date may include comparison of information concerning the balance at the balance-sheet date with comparable information at the interim date. This is an analytical procedure to identify amounts that appear unusual and that therefore need to be investigated. These analytical procedures can be combined with other analytical procedures or tests of details. Substantive analytical procedures are an efficient way to extend the audit conclusion from the interim date to the balance-sheet date.

Analytical procedures are particularly useful because the auditor's objective in performing roll-forward procedures is to evaluate whether the recorded amount of transactions between the interim date and the balance-sheet date is reasonable in relation to the auditor's expectation. Because the time period is much shorter than the annual period, the auditor's expectations can generally be developed with more precision. The period may be only one or two months. For example, if an auditor confirms service receivables as of May 30 for a governmental unit with a June 30 year end, analytical procedures might be an effective way of extending the auditor's conclusions through year end. Examples of analytical procedures that might be used as roll-forward procedures in this circumstance follow:

- Compare current-year June service revenue with prior-year June revenue.
- Compare the actual current-year service revenue to the budget.
- Compare the current-year June service revenue to the amount recorded in July of the next fiscal year.
- Review a month-by-month comparison of service revenue for the current year.

The auditor might also scan credit entries to service revenue in the first months of the next fiscal year. The scanning and comparisons of ratios and amounts may be supplemented by inquiries of department personnel about significant or unusual activity close to year end.

Generally, the lower the level of aggregation, the more precise the auditor's expectation. Month-to-month comparisons can be useful and effective in detecting significant differences caused by nonroutine journal entries recorded at the close of the fiscal period. The auditor might compare revenue and expense levels on a month-to-month basis, looking for peaks and valleys at period end.

Analytical Procedures and Accounting Estimates

The auditor identifies and evaluates significant accounting estimates made by management. SLG, Chapter 4, Appendix A, Paragraph A-14, provides the following examples of key estimates by state and local governments:

- Investments with no market-established fair value or with permanent impairments.
- Derivative instruments transactions.
- Uncollectible taxes receivable.
- Useful lives of capital assets that are being depreciated.
- Obligations for compensated absences.
- Claims and judgments.
- Termination benefits.
- Landfill closure and postclosure care costs.
- Pension benefits.
- Postemployment benefits other than pensions.
- Pollution remediation obligations.

The starting point is to identify the need for estimates using knowledge of the government and the results of risk assessment procedures. The next step is usually inquiry of management and accounting personnel responsible for identified estimates to obtain an understanding of the methods and procedures used to make the estimates.

Analytical procedures can be used in evaluating the reasonableness of estimates by developing the auditor's own expectation of the estimate and as a basis for assessing the overall reasonableness of the estimate. For example, in an audit of a governmental entity, the auditor might estimate the water utility customer accounts that will become uncollectible to be between $12,000 and $15,000. If the client has chosen to estimate $10,000 for uncollectibles, the auditor would consider the client's estimate to be outside the range of reasonableness.

Tests of the reasonableness of an accounting estimate often include a combination of tests of details and analytical procedures. Supporting data are tested for reliability using tests of details; analytical procedures are used to assess the reasonableness of the estimate. For example, the auditor might test the aging of accounts receivable for accuracy and then use the analytical procedures of scanning the aging, considering the historical trends of charge-offs per age category, and computing the ratio of days revenue in receivables and comparing to the prior year. The auditor might also scan the results of collection activity in the subsequent period.

How to Identify and Evaluate Significant Differences

After the auditor has developed an expectation of a recorded amount or ratio of recorded amounts from reliable data and compared the expectation to the recorded amount, the next step is to determine whether there is a significant difference. Authoritative literature does not define significant differences. If the difference is not significant, the account balance can be accepted as not misstated without performing additional audit work. If the difference is significant, an explanation for the difference should be obtained and corroborated. If a significant difference is not explained by corroborated information, the auditor typically reconsiders the effectiveness of the analytical procedure, performs additional procedures, or considers whether to treat the entire difference as a misstatement to be posted to the summary of audit differences. All these topics are discussed further in the following paragraphs.

AU-C 520B.A24 provides additional guidance and states that the amount of difference that can be accepted without further investigation is influenced by materiality and the level of assurance desired from the analytical procedure while taking into account the possibility that a misstatement may cause the financial statements to be materially misstated. If the difference is significant, the auditor should investigate the difference by—

- Inquiring of management and obtaining appropriate audit evidence to corroborate management's responses.
- Performing other audit procedures as necessary in the circumstances.

Evaluation of the Significance of Differences. The significance of a difference depends on what amount the auditor has determined is material individually and in the aggregate to the financial statements by opinion unit, rather than the percentage of the account balance. Typically, a 2% difference in total annual revenue would be very material to the financial statements, but a 20% difference in miscellaneous expenses may be immaterial. The practical issue is how to draw the dividing line between the amount that will require additional audit work and the amount that will be accepted without additional audit work. In establishing this line, the auditor has to recognize that the amount of the difference is not necessarily a reliable estimate of the amount of misstatement in the account balance. The expectation, rather than the account balance, might be wrong. The goal is to develop a workable rule of thumb for deciding whether further inquiry and investigation is necessary. If a difference is evaluated as not requiring further inquiry, the difference is not a misstatement and is not accumulated and posted to a summary of audit differences.

The authors believe that the range of 10% to one-third (or 33.33%) of performance materiality may provide a workable rule of thumb. Differences larger than the designated percentage would generally require investigation and corroboration of explanations. This guideline is based on the same framework that is used in many nonstatistical audit sampling plans, where the cutoff amount for individually significant dollar items is set at one-third of tolerable misstatement. The choice of a percentage within this range depends on the level of assurance desired from the substantive analytical procedure, which in turn depends on the auditor's risk assessment. If the substantive analytical procedure is the primary source of assurance, a percentage toward the low end of the range, say 10%, might be used. If the substantive analytical procedure is being used in combination with tests of details, then one-third of performance materiality might be used. If the substantive analytical procedure is only a supplement to a primary test of details, then a slightly higher amount might be used. As with all rules of thumb, these guidelines should not be applied mechanically. The suggested percentages should not be viewed as a bright-line, but merely a guide to assist the auditor in making an informed analysis of both qualitative and quantitative factors.

Corroboration of the Explanation of Differences. The auditor's expectation developed in performing substantive analytical procedures is an estimate or prediction of the amount of an account balance. The evaluation of the significance of the difference between the account balance and the expectation determines whether the account balance can be accepted as not misstated without performing additional audit work. If the auditor decides that the expectation is not effective (for example, not based on reliable enough data, not a precise enough expectation, etc.), then the test needs to be refined (such as further disaggregating the data), or the degree of assurance from the analytical procedure needs to be reduced.

If the auditor concludes that the expectation is sufficiently effective (that is, the expectation is precise enough), the auditor generally performs additional inquiry and analysis. The additional inquiry and analysis might result in a conclusion that the risk of misstatement of the account balance is acceptable, or alternatively, the quantification of a misstatement that will be proposed as an audit adjustment. Only the quantified estimate of misstatement determined by investigation is accumulated and posted to the summary of audit differences. A difference is not treated as a misstatement before investigating it. Although the difference may indicate one side of the entry needed to adjust the financial statements, it may not indicate the other side. If a significant difference has been investigated and the auditor has concluded that the risk of misstatement is acceptable, the difference is not posted to the summary of audit differences.

For significant differences, the auditor should obtain an explanation of the difference and corroborate the explanation. The auditor avoids the temptation of first asking those responsible for preparing financial statements to explain differences. The auditor obtains an explanation from a knowledgeable person who is preferably unrelated to financial statement preparation and analyzes the support for that explanation. Explanations about the reasons for differences might be obtained from accounting department personnel, but are also pursued with operating personnel and, in some cases, outside parties. For example, the auditor identifies an unexpected increase in the water and sewer service revenue. The accounting personnel explain that during the year, construction of a new housing development was completed and the city began billing for water and sewer service provided to the new occupants. The auditor may investigate the explanation by inspecting the water and sewer operations department's documentation of the new hookups and meter readings.

The nature and extent of corroboration needed is dependent on the circumstances and the nature of the risks that are present. In some cases, the client may have already made an investigation of a difference. For example, if the auditor's expectation was developed from budget information, there might be a detailed budget variance analysis. The auditor may inspect the analysis and discuss it with the preparer. If the variance analysis was made independently of the person responsible for the variance, the analysis might provide sufficient corroboration. In corroborating explanations of differences, the auditor may consider the results of other audit procedures and the enhanced understanding of the client obtained during the audit. This information might be sufficient and no additional evidence considered necessary. For example, a new housing development might be discussed in board minutes and correspondence with the housing developer. In some cases, consideration of a significant difference might cause the auditor to conclude that the development of the expectation missed important developments or considerations. Reexamination of the development of the expectation might explain the difference. When analyzing significant differences, the auditor considers whether there is a pattern of differences. Individual differences and the results of other audit procedures are not considered in isolation.

Because of the nature of analytical procedures, the auditor is usually not able to explain the entire amount of the difference. An explanation of the exact amount of the difference is not necessary. The auditor only has to corroborate a sufficient explanation to reduce the difference to an acceptable level. However, the investigation might not result in an acceptable difference and might instead indicate the existence of a misstatement. The auditor then considers the nature and cause of the misstatement and the most effective approach to quantifying the misstatement. The quantified misstatement is proposed as an audit adjustment.

How to Document Substantive Analytical Procedures

When substantive analytical procedures have been performed, the auditor should document (AU-C 520B.08)—

- the expectation and the factors used in its development (unless readily determinable from the work performed);
- the results of comparing recorded amounts to the expectation; and
- any additional procedures performed to address significant unexplained differences, and the results of those procedures (for example, the amount of any misstatement quantified as a result of the analytical procedures performed).

Exhibit 3-3 presents an example of documentation of a substantive analytical procedure that is the primary test of an account balance.

Exhibit 3-3

Documentation of Analytical Procedure

	6-30-X1	6-30-X0	Change
Personnel expense	$ 289,795	$ 345,960	$ (59,155)[a]

Note:

[a] We noted during our discussions with the client about its operations that during the year ended June 30, 20X0, the sanitation department switched from three-man trucks to two-man automated trucks for garbage collection. The city has six crews and did not change the number of crews. We noted from our review of the governing board minutes and newspaper and other media accounts that the switch to the new trucks, and the layoff of six men occurred midway through the year. The average wage per man was $19,220 last year, and we noted from review of payroll and personnel records that there were no salary increases in the sanitation department during the year. Thus, our expectation is that personnel expenses would decrease by one-sixth (one-third times one-half) or $57,600 ($345,960 times one-sixth) from that of the prior year as follows:

Prior-year expense (18 men @ $19,220)		$ 345,960
Current-year expected expense:		
18 men @ $19,220 × 50%	$ 172,980	
12 men @ $19,220 × 50%	115,320	
		$ 288,300
Current-year recorded expense		289,795
Difference		$ 1,495
Expected decrease		$ 57,600
Actual decrease		59,155
Difference		$ 1,495

Based on the above, personnel expense appears reasonable and no further work is considered necessary.

Documentation of the expectation and the factors considered in its development is required if not apparent from the work performed. When prior year balances or budgeted amounts are used for comparative purposes, those amounts implicitly represent the auditor's expectation. In that case, if the workpapers include a comparative schedule showing the prior year or budgeted amounts and indicating the source of those amounts (for example, prior-year workpapers or the 20X2 budget), the authors believe that the expectation is apparent and that no additional documentation of the expectation is necessary. For an expectation developed based on the key factors affecting an account, such as an expectation of compensation expense developed using information about the number of employees and pay rates, auditors ought to document the factors used in its development and the source of information about those factors. The results of comparing the expectation with recorded amounts may be documented by including a variance column on the auditor's comparative schedule or by documenting the comparison of the expected amount and the recorded amount on the face of the auditor's calculation.

Although not required by authoritative literature, documentation might also include information about the auditor's approach to evaluating the significance of the difference between the recorded amount and the expectation (for example, a percentage of performance materiality rule of thumb).

Practice Aids and Documentation

The practice aids provided in *PPC's Guide to Audits of Local Governments* provide space for documenting the information about substantive analytical procedures listed above, such as the performance of analytical procedures including development of an expected amount and the calculation of ratios. Some auditors may prefer to adapt the formats for use in electronic spreadsheets. By using such a spreadsheet, once the information is captured, all computations and comparisons can be automated.

SELF-STUDY QUIZ

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

19. As part of a governmental audit, Flynn inspects supporting documents for a cash disbursement. This is an example of which of the following?

    a. An external confirmation.

    b. A substantive analytical procedure.

    c. A test of balances.

    d. A test of transactions.

20. Which of the following are used to obtain audit evidence about potential misstatements?

    a. Analytical procedures.

    b. Overall review analytical procedures.

    c. Preliminary analytical procedures.

    d. Substantive analytical procedures.

21. How might a government's budgetary process affect the use of substantive analytical procedures?

    a. The auditor may use this data to develop expectations for the procedures.

    b. The auditor should test such data rather than make inquiries about it.

    c. The auditor should focus on the actual budget once it supersedes the original plan.

    d. The budget is typically a formality so the auditor does not need to spend much time on it.

22. Which of the following statements best describes the documentation requirements for substantive analytical procedures?

    a. The documentation should be done before the procedures are performed.

    b. Documentation of the expectation and factors used for its development is required.

    c. The results of comparisons made to the expectation should be documented.

    d. A note about whether additional procedures were performed should be included.

SELF-STUDY ANSWERS

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

19. As part of a governmental audit, Flynn inspects supporting documents for a cash disbursement. This is an example of which of the following? **(Page 275)**

    a. An external confirmation. [This answer is incorrect. AU-C 505B.06 defines an *external confirmation* as a direct response to the auditor from a third party either in paper form or by electronic or other means, such as through the auditor's direct access to information held by a third party. As a third party was not involved in this scenario, Flynn did not perform an external confirmation.]

    b. A substantive analytical procedure. [This answer is incorrect. An auditor's substantive procedures are generally made up of both tests of details and substantive analytical procedures. Flynn's inspection, as described above, would fall into the tests of details category, as it is not a substantive analytical procedure.]

    c. A test of balances. [This answer is incorrect. Tests of balances are tests applied directly to the details of balances in general ledger accounts (e.g., confirming the balances of accounts in the service accounts receivable subsidiary ledger with individual customers). Flynn's procedure would not fall into this category.]

    d. **A test of transactions. [This answer is correct. Tests of details may be applied to transactions or balances. Tests of transactions are tests of individual transactions by obtaining supporting evidence of the transaction, such as inspection of the documents and accounting records involved in processing (e.g., inspecting supporting documents for a cash disbursement, as Flynn did in this scenario).]**

20. Which of the following are used to obtain audit evidence about potential misstatements? **(Page 277)**

    a. Analytical procedures. [This answer is incorrect. *Analytical procedures* are evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data. They include trend analysis, ratio analysis, and predictive or reasonableness tests. This is an overarching category that includes all three of the other answer choices; therefore, there is a better and more specific answer to this question.]

    b. Overall review analytical procedures. [This answer is incorrect. According to AU-C 520B.06, *overall review analytical procedures* are part of the final review of the financial statements to assure that the numbers make sense. This final step in the audit is made to be sure that the auditor has obtained a sufficient understanding of the financial statements during the audit. By the time such analytical procedures are performed, the auditor should already have the necessary evidence about potential misstatements.]

    c. Preliminary analytical procedures. [This answer is incorrect. According to AU-C 315B.06 and AU-C 315B.A14, *preliminary (planning) analytical procedures* are used to enhance the auditor's understanding of the governmental unit and assist in assessing areas of specific risk of misstatement by identifying unexpected relationships among account balances or the absence of expected relationships. They are an important step in audit planning and risk assessment and, as such, they would be performed prior to the procedures described in this question.]

    d. **Substantive analytical procedures. [This answer is correct. As discussed in AU-C 520B.05, *substantive analytical procedures* are used to obtain evidence about potential misstatements. They are focused on particular account balances and relevant assertions, and the auditor will have already assessed the risk of misstatement of the relevant assertion, including the likely direction of the misstatement.]**

21. How might a government's budgetary process affect the use of substantive analytical procedures? **(Page 280)**

    a. **The auditor may use this data to develop expectations for the procedures. [This answer is correct. The budget data can be a good source of auditor expectations. For example, the auditor can use the budgeted amount for an account balance as the auditor's expectation of the recorded amount.]**

    b. The auditor should test such data rather than make inquiries about it. [This answer is incorrect. The auditors may inquire of management and personnel who develop the budget about what relationships are known to be effective predictors. This will help the auditors design their substantive analytical procedures.]

    c. The auditor should focus on the actual budget once it supersedes the original plan. [This answer is incorrect. The auditor may want to consider using the original budget to determine variances from actual. The auditor can then determine why actual amounts changed from the original estimate, especially if the entity amends the budget to mirror actual activity.]

    d. The budget is typically a formality so the auditor does not need to spend much time on it. [This answer is incorrect. Most governmental units are subject to budget and appropriation laws, which are established by statutes, constitutional provisions, etc. Thus, once adopted or appropriated, budgets and appropriations usually have the force of law. Because the adopted budget is so important, governmental accounting systems and financial reporting are designed to facilitate and demonstrate adherence to the budget. Therefore, the budget will be an important factor in the audit.]

22. Which of the following statements best describes the documentation requirements for substantive analytical procedures? **(Page 290)**

    a. The documentation should be done before the procedures are performed. [This answer is incorrect. Based on the guidance in AU-C 520B.08, such documentation is done after substantive procedures have been performed.]

    b. Documentation of the expectation and factors used for its development is required. [This answer is incorrect. Per AU-C 520B.08, the expectation and the factors used in its development should be documented *unless* they are readily determinable from the work performed.]

    c. **The results of comparisons made to the expectation should be documented. [This answer is correct. As discussed in AU-C 520B.08, when documenting substantive analytical procedures, auditors should include the results of comparing recorded amounts to the expectation that they developed for the procedure.]**

    d. A note about whether additional procedures were performed should be included. [This answer is incorrect. Per AU-C 520B.08, any additional procedures performed to address significant unexplained differences and the results of those procedures should be recorded. Merely including a note about whether such additional procedures were performed would not be adequate documentation.]

OTHER ISSUES THAT MAY ARISE RELATED TO SUBSTANTIVE PROCEDURES

The Use of Audit Evidence from Prior Periods

The ability to use audit evidence from the performance of substantive procedures in a prior audit is highly restricted. AU-C 330.A60, as amended by SAS No. 135, notes that in most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. Prior evidence substantiating the purchase cost of a building or building addition is one example of an instance in which audit evidence obtained from the performance of substantive procedures in a prior period may be relevant in the current period. This example is the common audit approach to auditing capital assets by substantiating the changes to the beginning balance—additions and retirements—to reach a conclusion about the ending balance. Before using audit evidence obtained from the performance of substantive procedures in a prior audit, the auditor considers whether the audit evidence and the related subject matter have fundamentally changed and performs audit procedures during the current period to establish the continuing relevance of the audit evidence. As a general matter, the auditor's knowledge and experience from performing substantive procedures in prior audits is helpful in identifying risks of material misstatement for audit planning purposes, but does not provide substantive assurance in the current audit other than in circumstances in which the audit approach assumes that the opening balance audited in the prior year is not materially misstated.

Responding to Fraud Risks

The auditor is responsible for designing and performing the audit to obtain reasonable assurance of detecting material misstatements, whether caused by error or fraud. The auditor is required to specifically identify and assess risks of material misstatement due to fraud and develop an appropriate response. Based on the auditor's assessment of fraud risks, he or she may alter the nature of procedures performed (that is, apply additional procedures designed to detect fraud), or alter the timing or extent of procedures performed. The auditor may also require more or different evidence to support material transactions or balances than would be the case if the auditor did not identify any specific fraud risks. In addition, auditors are required to perform certain specific procedures to address the risk of management override of controls, including examining journal entries and other adjustments, reviewing accounting estimates for bias, and evaluating the business rationale for significant unusual transactions. The authors believe that the response to fraud risk may differ significantly for risks of fraudulent financial reporting versus misappropriation of assets. Accordingly, the authors suggest that auditors assess these risks separately and develop an overall or specific response tailored to those differing fraud risks.

Overall Responses. Auditors generally use overall responses to address fraud risks that are pervasive to the financial statements. Overall responses affect the audit strategy (that is, the way the audit is conducted). Because there is always at least one identified fraud risk (the risk of management override of controls), certain overall responses are required in every audit.

Specific Responses. Specific responses to fraud risks involve the nature, timing, and extent of auditing procedures. Specific responses at the account balance, transaction class, or financial statement assertion level will vary depending on the types and combinations of fraud risks identified and the account balances, classes of transactions, or assertions that may be affected. Responses may involve both substantive procedures and tests of controls. However, tests of controls alone will not reduce audit risk to an appropriately low level because of the risk that management may override controls; therefore, tests of controls alone are not sufficient to respond to fraud risks.

When responding to fraud risks, the auditor may need to modify the nature, timing, and extent of audit procedures in the following ways:

- The *nature* of audit procedures may be modified to obtain more reliable evidence (such as evidence from independent sources outside the government or evidence from tests of details rather than analytical procedures) or additional corroboration.
- The *timing* of audit procedures may be modified to perform more substantive procedures at year-end (for example, if interim audit procedures are planned, but there are unusual incentives for management to

engage in fraudulent financial reporting). Alternatively, substantive tests of transactions throughout the year may be performed to respond to the risk of fraud initiated in an interim period.

- The *extent* of audit procedures may be modified through larger sample sizes or by performing analytical procedures at a more detailed level to achieve a higher degree of precision.

SLG, Chapter 4, Appendix A, Paragraph A-17b, provides the following examples of specific responses to identified fraud risks involving the nature, timing, and extent of procedures to be performed in a state and local government audit:

- Confirming transaction details, such as for grants and tax collections, with other governments pertaining to year-end cut-offs.
- Making additional inquiries or performing other procedures on the collectability of interfund receivables, including particularly large, continuing balances.
- Increasing sample sizes when testing writeoffs of uncollectible taxes or other receivables.
- Analyzing investment income by type and time period.
- Using a specialist (internal or external) to recalculate complex estimates, such as liabilities for pollution remediation obligations or landfill closure and postclosure care costs.
- Confirming compensated absences balances with employees.
- Observing capital assets and evaluating qualification for capitalization for financial reporting purposes.
- Scanning journal entries for unusual items.
- Counting cash collections on a surprise basis.

Professional Skepticism. When gathering and evaluating audit evidence in response to identified fraud risks, auditors need to maintain an appropriate degree of professional skepticism. Examples of applying professional skepticism in response to risks of material misstatement due to fraud include—

- An increased recognition of the need to corroborate client explanations or representations (for example, through further analytical procedures, third-party confirmation, examination of independent documentation, or discussions with others within or outside the entity).
- Performing additional or different auditing procedures to obtain more reliable evidence in support of the auditor's objectives.

Responding to the Risk of Misappropriation of Assets. Auditors may be faced with unique considerations when determining how to respond to the risk of material misstatement due to misappropriation of assets. The auditor's response most likely will be directed at a specific account balance or transaction class. Responding to an apparent risk of misappropriation can be challenging. Misappropriation of immaterial amounts may be relatively common, but it is less common for misappropriation to occur in amounts considered material to financial statements.

When a client has assets that are particularly susceptible to misappropriation (such as large amounts of cash on hand or other assets that are valuable and easily stolen) and the auditor has concluded there is a risk of material misstatement of the financial statements due to misappropriation, an appropriate audit response generally would be to perform more extensive substantive testing of the balance in the financial statements. That may include physically inspecting the assets at or near year end. The auditor also might want to examine accounts in which misappropriation could be concealed, such as accounts with a large number of small debit transactions. Substantive analytical procedures using expectations developed with a high degree of precision also may be effective. In some cases, the auditor might decide it is necessary to test the effectiveness of controls designed to prevent or detect such misappropriation. AU-C 240B.A76 states that the scope of work is to be linked to the specific information about the misappropriation risk that has been identified.

In some governments, one of the primary fraud risks is fraudulent, unauthorized disbursements (for example, bookkeepers writing checks to themselves). Some governments are particularly susceptible to such fraud because of a lack of segregation of duties. If the auditor concludes there is a risk that such disbursements may occur in amounts that could result in material misstatement of the financial statements, an audit response is required. Substantive tests of the cash balance recorded in the financial statements may not be sufficient to respond to a material risk of fraudulent cash disbursements.

The auditor first identifies the client's controls over disbursements, such as the following:

- Segregation of duties and effective management oversight (for example, a senior official receives the bank statement unopened).
- Authorization and approval of cash disbursement transactions (for example, in purchasing or payroll disbursements).

If, after identifying controls and the risk that fraudulent disbursements could be material to the financial statements, the auditor determines that an additional audit response is necessary, the following procedures might be considered:

- Testing controls over disbursements.
- Performing extended analytical procedures on expense accounts.
- Reviewing selected disbursements for unusual payees, signatures, or endorsements.
- Reviewing vendor lists for unusual patterns.
- Reviewing vendor lists with management for unauthorized vendors.
- Reviewing payroll registers for unusual items.
- Performing paymaster procedures (that is, distributing payroll checks or observing their distribution).
- Proof of cash.

Regardless of the auditor's judgments about whether the risk of material, fraudulent disbursements is an identified fraud risk, the auditor should communicate significant deficiencies in controls in accordance with professional standards. In addition, the auditor may consider working with the client management, when necessary, to provide guidance to them on establishing effective controls over disbursements. However, the auditor would need to consider the requirements of ET 1.295 and not accept responsibility for the design, implementation, or maintenance of internal control.

Misstatement of the Financial Statements Due to Misappropriation of Assets. GAAP does not distinguish, as auditing standards do, between errors and fraud, and labels all misstatements as errors. When a misappropriation of assets has occurred, the auditor has to evaluate whether separate disclosure of the nature and amount of the misappropriation is necessary because knowledge of the matter would influence the judgment of a user of the financial statements. Neither GAAP nor GAAS provides guidelines unique to this issue for evaluating materiality. The authors believe that misappropriations of this type are regarded as more significant and the disclosure more important when: (a) the misappropriation is by more senior levels of management, (b) the control deficiencies that permitted the misappropriation have not been corrected, or (c) users of the financial statements are generally regarded as more sensitive to fraud, waste, and abuse, such as is the case for governments.

One troublesome issue related to misappropriation of assets often is referred to as the cost of goods stolen issue. For example, assume that employee theft of an asset occurs in amounts that would be considered material to the financial statements. However, assets still on hand at the date of the financial statements are accurately reflected on the financial position statement, and the theft is washed through as an expenditure or expense. Practitioners disagree on whether such financial statements are materially misstated, and auditing literature does not attempt to resolve the issue. The same issue exists for other types of misappropriation. An example would be the personal use of funds by management with the costs being charged as an expenditure or expense. However, consideration has to be given to the qualitative aspects of materiality. For example, implications of potential misstatements that might otherwise be immaterial could be significant to financial statement users because they involve misappropriation of assets, or senior government officials. Although the change in fund balance or net position may be correctly stated, there could be material classification and presentation and disclosure issues.

The auditor who concludes that an audit response is necessary to detect the costs of misappropriated assets reflected in financial statements generally would respond by modifying the nature, timing, or extent of procedures ordinarily used to test revenue and expenditure/expense accounts. Revenue and expenditure/expense accounts are ordinarily tested through analytical procedures, tests of transactions, scanning for unusual amounts, or some combination thereof. The use of analytical procedures, including the development by the auditor of an expected dollar amount at a tight level of precision to be compared with the recorded amount, may be an effective response to a risk of material misstatement due to misappropriation of assets.

Responses to Further Address the Risk of Management Override of Controls. Because management has the ability to override controls that may otherwise appear to be operating effectively, and because that occurrence is unpredictable, AU-C 240.32, as amended by SAS No. 135, requires auditors to address that risk. In addition to the auditor's overall and specific responses to identified fraud risks, auditors should perform the following procedures to further address the risk of management override of controls:

- Examine the government's journal entries and other adjustments.
- Review accounting estimates for bias.
- Evaluate the business purpose of significant unusual transactions.

<u>Examining Journal Entries.</u> Both AU-C 240B and AU-C 330B.21 require examining journal entries and other adjustments. However, the nature, timing, and extent of procedures required by AU-C 240B are different from those required by AU-C 330B. AU-C 330B focuses on journal entries made during the course of preparing the financial statements. AU-C 240B, which focuses on identifying fraudulent journal entries resulting from management override of controls, requires the auditor to consider reviewing journal entries made throughout the period. Auditors should examine both journal entries recorded in the general ledger and other adjustments (such as post-closing or reclassifying entries) made in preparing the financial statements.

To test the appropriateness of journal entries, AU-C 240.32, as amended by SAS No. 135, requires that the auditor—

- Obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of such controls.
- Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
- Consider fraud risk indicators, the nature and complexity of accounts, and unusual entries processed.
- Select journal entries and other adjustments made at the end of a reporting period.
- Consider the need to test journal entries and other adjustments throughout the period.

If the auditor has identified risks of management override of controls and determines that the procedures outlined in the previous paragraph do not adequately respond to those risks, additional procedures should be performed (AU-C 240B.33). The auditor designs those procedures to adequately respond to the identified risks of management override of controls.

When selecting journal entries for testing and designing tests, the auditor may consider:

- The assessed risk of material misstatement due to fraud related to specific classes of journal entries.
- The effectiveness of controls over financial reporting (if the auditor tests those controls). However, even if the auditor has tested controls over journal entries and determined they are operating effectively, it is still necessary to identify and test specific entries.
- How the entity processes journal entries and what audit evidence is available.

- The presence of suspicious characteristics, such as entries to unrelated, unusual, or seldom-used accounts; entries by employees not expected to make journal entries; entries made at or near the end of the period or as post-closing entries with little or no explanation; entries without account numbers; or entries containing rounded or consistent ending numbers.
- The nature and complexity of the accounts, locations, or components containing the journal entries. Unusual journal entries are often associated with accounts that contain complex or unusual transactions, significant estimates and year-end adjustments, or related party transactions. Accounts prone to errors in the past and unreconciled accounts may also be associated with a higher risk of material misstatement due to fraud.
- Whether the entries are for standard, recurring estimates or transactions such as monthly depreciation, or for nonstandard, nonrecurring estimates or transactions, such as asset impairment.
- Whether the entries are subject to the entity's normal internal controls. Nonstandard, nonrecurring entries and adjustments may not be subject to the same level of internal control as standard, recurring entries.
- The need to select entries from different locations or components of the entity.
- Journal entries that are reversed at the beginning of the subsequent period.

The nature, timing, and extent of tests of journal entries is determined by considering the facts and circumstances such as those described above. The procedures ordinarily include examining the general ledger to identify entries for testing; reviewing supporting documentation; and evaluating whether entries are properly approved, adequately supported, properly posted, and appropriately reflect the underlying events and transactions. For most audits, the authors believe tests of journal entries may be performed at year end. If examination of the ledger to identify entries for testing is initially performed before year end, those procedures generally need to be extended to year end.

<u>Reviewing Accounting Estimates.</u> AU-C 240B.32 requires that the auditor consider the possibility of management bias in the development of accounting estimates. In other words, an auditor should 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. In that case, the auditor should consider whether other recorded estimates reflect a similar bias and perform additional procedures to address those estimates.

AU-C 240B.32 further requires auditors to perform a retrospective review of significant prior-year accounting estimates. The retrospective review includes reviewing information available in the current year and comparing that information to significant estimates recorded in the prior year. The intent of the review is not to question the auditor's judgment in the prior year, but to determine, with the benefit of hindsight, whether the underlying assumptions in the prior year might indicate possible bias on the part of management. The review may provide additional information about whether the current year's estimates could be biased. Significant estimates selected for retrospective testing should include those that are highly subjective or may change significantly based on the underlying assumptions and judgments. If auditors identify possible bias on the part of management in making accounting estimates, they consider whether the bias indicates a risk of material misstatement due to fraud, that is, intentional manipulation of the financial statements, and develop an appropriate response.

<u>Evaluating Significant Unusual Transactions.</u> AU-C 240.32, as amended by SAS No. 135, requires auditors to gain an understanding of the business purpose for significant unusual transactions. Understanding the business purpose (or lack thereof) of significant unusual transactions may provide an indication that transactions were entered into for the purpose of engaging in fraudulent financial reporting or to conceal misappropriation of assets. The procedures should include the following:

- Read the documentation for the transaction and evaluate whether the information about the transaction is consistent with explanations obtained from inquiries and other audit evidence about the transaction's business purpose (or the lack thereof).
- Determine whether the entity's policies and procedures for authorization and approval of the transaction were followed.

- Evaluate whether significant unusual transactions identified by the auditor have been properly accounted for and disclosed in the financial statements.

Examples of factors auditors may consider in evaluating business purpose include whether:

- The transaction is overly complex in relation to its stated purpose.
- Management is overly concerned that the transaction receives a particular accounting treatment.
- The transaction involves previously unidentified related parties.
- The parties to the transaction or the transaction itself lack economic substance.
- The transaction and the manner of accounting have not been reviewed and approved at an appropriate level, such as by those charged with governance.
- The transaction does not make business sense from the perspective of the other party.

Effect on Audit Programs. Auditors consider their assessments of specific fraud risks identified and the expected effectiveness of planned procedures (basic procedures in the core audit programs) in determining whether additional procedures need to be performed to respond to those fraud risks. If the auditor chooses to respond to fraud risks by changing the nature of the auditing procedures, the additional procedures to many of the core audit programs include procedures the auditor may consider performing in response to his or her assessment of fraud risks. Tailoring audit programs was discussed in detail in Lesson 2.

Due to the nature of fraud and the methods by which it may be committed, it is not possible to develop a comprehensive set of standardized procedures that need to be performed in response to an auditor's assessment of fraud risks. The auditor needs to assess risks of material misstatement due to fraud at the assertion level and exercise due professional care and professional skepticism in developing procedures that provide the auditor with reasonable assurance that a material misstatement of that assertion will be detected. In some cases, the standardized procedures in the audit programs in *PPC's Guide to Audits of Local Governments* may not be sufficient to respond to the risks identified, and the auditor will need to design procedures that are specific to the facts and circumstances of the identified risks, and focused directly at the detection of fraud. These procedures may be of a forensic nature. For example, AU-C 240.A77, as amended by SAS No. 135, explains procedures responsive to risks of fraud due to misappropriation of assets, including using computerized procedures to match a vendor list with personnel data to identify matches of addresses or phone numbers and searching payroll records to identify duplicate addresses, taxing authority numbers (i.e., social security numbers), or bank accounts.

Documenting Fraud Risk Responses. AU-C 240B.44 requires that the auditor document—

- 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.

There is not a one-to-one correlation between risks and responses. That is, one response may address several fraud risks, and one risk may require several responses. The responses to identified fraud risks may be documented individually or in combination.

Completeness—the Elusive Assertion

Another relatively complex and somewhat controversial issue is how to test the completeness assertion. Some auditors believe that sufficient audit evidence about completeness cannot be obtained without some tests of controls because substantive procedures are often not effective in testing completeness. The authors believe tests of controls are not necessarily required to satisfy audit objectives about the completeness assertion. If the auditor believes there is a risk that transactions have been improperly omitted from the financial statements, the auditor reduces that risk by performing some substantive procedures to obtain evidence about the completeness assertion.

The substantive procedures will be either analytical procedures or tests of related populations. (A related population is an account balance or transaction class other than the one being assessed for completeness that would be expected to contain evidence of whether all transactions are included in the balance or class being assessed, such as examining subsequent cash disbursements for unrecorded payable.)

Procedures Related to Completeness. A variety of procedures are available that provide evidence relevant to completeness. Some provide direct evidence that for a particular account balance or class of transactions there is reasonable assurance of completeness. Others are less direct but increase an auditor's confidence that the financial reporting system has captured all transactions. These procedures are as follows:

a. *Observation and Inquiry.* To obtain information about the control consciousness of management the competence and integrity of employees, and the condition of the accounting records and operation of the financial reporting system.

b. *Analytical Procedures.* To obtain information about the reasonableness and completeness of account balances and the totals of classes of transactions.

c. *Tests of Details of Transactions.* To obtain direct evidence that a population of accounting data is complete.

d. *Management Representations.* To obtain corroboration from management on the completeness of recorded transactions and other relevant representations. Management representations are not a substitute for other audit procedures and cannot be the sole source of evidence, but may complement other procedures.

THE TIMING OF SUBSTANTIVE PROCEDURES

As part of audit planning, an auditor can consider whether any substantive procedures may be applied before the financial statement position date. Generally, the most efficient approach for audits of small local governments is to perform the audit tests as of the financial statement position date. Nevertheless, the auditor may wish to perform audit procedures before the financial statement position date in the following situations:

- *Practice Management Considerations.* If the auditor has many 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.

- *Issue Identification.* Interim audit work allows the auditor to identify and address critical audit issues as soon in the engagement as possible. Then the auditor and client can more easily deal with issues without deadline pressures arising near year end, which in turn can enhance audit efficiency and client relations.

- *Assessed Risks of Material Misstatement.* Modifying the timing of substantive procedures is one response to the assessed risks of material misstatement due to error or fraud. In general terms, the higher the assessed risk of material misstatement, the more likely it is that the auditor will determine that it is more effective (or necessary due to certain fraud risks) to perform substantive procedures near the period end. However, as the assessed risks diminish, the auditor may determine that an appropriate response would include the performance of certain substantive procedures at an interim date. Also, as AU-C 240B.A43 points out, a response to some identified fraud risks, such as fraudulent revenue recognition, might be to apply substantive procedures to transactions occurring earlier in or throughout the reporting period. An overall response to identified risks might be to add an element of unpredictability in the timing of audit procedures from year to year, such as by performing tests at a time other than that expected.

In testing transactions, the auditor needs to normally select transactions from the entire period under audit. If the auditor can obtain reasonably accurate estimates of the number and total dollar amount of the transactions for the fiscal period under audit, a portion of this work can be done at any convenient interim date. The remainder of the testing may be completed as part of year-end procedures.

Consideration of Incremental Risk of Material Misstatement

When interim audit procedures are performed, there is increased risk because the conclusions reached at the interim date cannot be extended effectively to the balance-sheet date. This remaining period or incremental risk tends to rise with increases in the following factors:

- Assessed risk of material misstatement from either error or fraud.
- Length of the remaining period (that is, the period from the interim date to the balance-sheet date).

Generally, the greater the remaining period risk, the greater the assurance needed from tests of the remaining period. For example, if the remaining period risk is low, the auditor can generally test the remaining period through limited analytical procedures. However, if the remaining period risk is high, the auditor would generally need to apply more reliable procedures, such as tests of details. In some high-risk cases, the auditor might even need to reapply some of the interim procedures to period-end balances.

When deciding whether and when to perform substantive procedures at an interim date, the auditor considers whether the tests that would be performed for the remaining period will adequately reduce the incremental risk that misstatements that exist at period end are not detected. Consequently, it may be more efficient to apply interim audit procedures to lower-risk areas or assertions. For example, if the client had a high risk relating to valuation but moderate or low risk for existence, the auditor might decide to test existence at an interim date and valuation at year end. In another example, if there is a risk of overstated revenues, the auditor may determine that the relevant assertions of existence and cutoff can only be effectively tested at period end because the risk may be greater at the end of the reporting period.

SELF-STUDY QUIZ

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

23. Why might auditors modify the extent of their audit procedures when responding to fraud risks?

    a. To obtain more reliable evidence.

    b. To obtain additional corroboration.

    c. To perform more procedures at year-end.

    d. To achieve a higher degree of precision.

24. Ray is auditing a governmental entity that's primary fraud risk is fraudulent, unauthorized disbursements. He determines that substantive tests of the cash balance recorded in the financial statements is not sufficient to respond to the material risk of fraudulent cash disbursements. Which of the following should Ray do first?

    a. Perform extended analytical procedures on expense accounts.

    b. Identify controls over disbursements.

    c. Test controls over disbursements.

    d. Review payroll registers for unusual items.

SELF-STUDY ANSWERS

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

23. Why might auditors modify the extent of their audit procedures when responding to fraud risks? **(Page 296)**

    a. To obtain more reliable evidence. [This answer is incorrect. The *nature* (not the extent) of audit procedures may be modified to obtain more reliable evidence, such as evidence from independent sources outside the government or evidence from tests of details rather than analytical procedures.]

    b. To obtain additional corroboration. [This answer is incorrect. Auditors might modify the *nature* of their audit procedures to gather additional corroboration. Modifying the extent of their existing audit procedures generally has a different goal.]

    c. To perform more procedures at year-end. [This answer is incorrect. The *timing* of audit procedures (not the extent) may be modified to perform more substantive procedures at year-end (e.g., if additional procedures are planned, but there are unusual incentives for management to engage in fraudulent financial reporting.]

    d. **To achieve a higher degree of precision. [This answer is correct. The *extent* of audit procedures may be modified through larger sample sizes or by performing analytical procedures at a more detailed level to achieve a higher degree of precision.]**

24. Ray is auditing a governmental entity that's primary fraud risk is fraudulent, unauthorized disbursements. He determines that substantive tests of the cash balance recorded in the financial statements is not sufficient to respond to the material risk of fraudulent cash disbursements. Which of the following should Ray do first? **(Page 298)**

    a. Perform extended analytical procedures on expense accounts. [This answer is incorrect. Ray might perform this procedure in this scenario, but there is something else he would need to do first.]

    b. **Identify controls over disbursements. [This answer is correct. In some governments, one of the primary fraud risks is fraudulent, unauthorized disbursements. Some governments are particularly susceptible to such fraud because of a lack of segregation of duties. If the auditor concludes there is a risk of such disbursements may occur in amounts that could result in material misstatement of the financial statements, an audit response is required. Substantive tests of the cash balance recorded in the financial statements may not be sufficient to respond to a material risk of fraudulent cash disbursements, such as in the scenario above. The first thing the auditor would do in this situation is to identify the client's controls over disbursements, such as (1) segregations of duties and effective management oversight and (2) authorization and approval of cash disbursement transactions. Once Ray does this, he might then select procedures for an additional audit response.]**

    c. Test controls over disbursements. [This answer is incorrect. Ray might test such controls in response to this situation; however, there is something else he would need to do first.]

    d. Review payroll registers for unusual items. [This answer is incorrect. Reviewing payroll registers for unusual items and performing paymaster procedures are procedures Ray might find effective for an additional audit response; however, he would not perform these procedures without doing something else first.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 2—Important Considerations for Performing Governmental Audits (ALGTG212)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. 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 those 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 the PDF and can be printed if needed.

2. **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 $109 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.

3. **PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. 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
     ALGTG212 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.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 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 $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (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.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **April 30, 2022**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 2—Important Considerations for Performing Governmental Audits (ALGTG212)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. School districts and utilities are considered which of the following?

   a. Business enterprises.

   b. Component units.

   c. General governments.

   d. Special purpose governments.

2. Which of the following is one important way governmental units differ from business enterprises?

   a. They have a strong profit motive.

   b. They are empowered to render services to citizens.

   c. They are prohibited from raising revenues.

   d. Their activities are less likely to be socially motivated.

3. Use of the word *must* in the generally accepted auditing standards (GAAS) represents which of the following?

   a. An unconditional requirement.

   b. A presumptively mandatory requirement.

   c. An optional requirement.

   d. An outdated or superseded requirement.

4. Within the AICPA *Professional Standards,* what numbering indicates one of the core or primary standards?

   a. AU-C XXX.

   b. AU-C XXXA.

   c. AU-C XXXB.

   d. QC XX.

5. What piece of auditing guidance deals specifically with the application of GAAS to a compliance audit?

   a. AU-C 200B.

   b. AU-C 220B.

   c. AU-C 500A.

   d. AU-C 935B.

6. Which of the following make up category A of the hierarchy of governmental generally accepted accounting principles (GAAP)?

   a. FASB pronouncements.

   b. GASB Implementation Guides.

   c. GASB Statements.

   d. GASB Technical Bulletins.

7. Which of the following is considered a governmental category fund?

   a. An enterprise fund.

   b. An internal service fund.

   c. An investment trust fund.

   d. A special revenue fund.

8. An enterprise fund can be used to account for which of the following?

   a. All of a government's financial resources that are not accounted for elsewhere.

   b. Activities for which a fee is charged to external users for goods or services.

   c. Financial resources restricted, committed, or assigned to be used for capital outlay.

   d. The financing of goods or services provided by one governmental department to another.

9. The amount that would be received for an asset on the measurement date in an orderly transaction between market participants in the principal or most advantageous market is the asset's what?

   a. Fair value.

   b. Historical cost.

   c. Replacement cost.

   d. Settlement amount.

10. A narrative report prepared by a government's financial manager in an easy-to-read format that introduces the financial statements and provides an analytical view of the government's financial activities is called what?

    a. Government-wide financial statements.

    b. Notes to the financial statements.

    c. Management's discussion and analysis (MD&A).

    d. Infrastructure condition data.

11. If a transmittal letter is presented in the comprehensive annual financial report (CAFR), the government should—

    a. duplicate the information that was included in the MD&A.

    b. elaborate on information from the MD&A.

    c. omit any subjective or prospective information.

    d. avoid information on unrequired components.

12. Which of the following special purpose frameworks are most commonly used by governmental entities?

    a. The contractual basis or an other basis.

    b. The regulatory basis or the contractual basis.

    c. The cash basis or the tax basis.

    d. The cash basis or the regulatory basis.

13. According to *Government Auditing Standards* (the Yellow Book), the concept of integrity includes which of the following?

    a. Being honest, candid, fact-based, and nonpartisan.

    b. Having an attitude of impartiality.

    c. Being independent in fact and appearance.

    d. Working toward the collective well-being of the community.

14. How has the COVID-19 pandemic affected CPE requirements for auditors who perform engagements under GAGAS?

    a. Auditors are prohibited from carrying over CPE to the next two-year measurement period.

    b. The 80-hour CPE requirement is waived for the affected two-year CPE period.

    c. Existing CPE exemptions in the Yellow Book can be used when the auditor is working remotely.

    d. The affected two-year CPE measurement period is given an extra six-month grace period.

15. Which statement best describes how Single Audits differ from other governmental audits?

    a. If auditors fulfill all the requirements from the Single Audit Act, they are no longer responsible for the requirements in GAAS or the Yellow Book.

    b. Auditors are required to report on supplementary information on federal awards programs that accompanies the basic financial statements.

    c. Auditors can choose to perform fewer tests of internal control over federal award programs.

    d. Auditors are prohibited from expressing an opinion on the governmental entity's compliance with laws and regulations.

16. What management says, either explicitly or implicitly, about the recognition, measurement, presentation, and disclosure of information in the financial statements and financial statement disclosures is referred to as what?

    a. Assertions.

    b. Assessment.

    c. Categories.

    d. Misstatements.

17. When gathering information that may be relevant to identifying risks in a governmental audit, auditors should do which of the following?

    a. Dispose of the information quickly.

    b. Limit information collected for audit efficiency.

    c. Assume the information is final, not raw material.

    d. Collect as much information as seems relevant.

18. The synthesis process helps an auditor do which of the following?

    a. Identify individual occurrences of fraud.

    b. Determine a specific amount by which the financial statements are misstated.

    c. Articulate what might go wrong at the relevant assertion level.

    d. Segregate pieces of information based on individual qualities.

19. The risk of material misstatement is made up of what two components?

    a. Audit risk and detection risk.

    b. Detection risk and control risk.

    c. Inherent risk and control risk.

    d. Inherent risk and audit risk.

20. Which of the following is a characteristic of an audit area?

    a. An audit area is made up of either account balances, transaction classes, or disclosures.

    b. An audit area is a mixture of balances, transactions, and disclosures related to a common operation.

    c. One audit area is of the same significance as any other audit area.

    d. Audit areas must be organized by revenue cycle.

21. Significant risks are more likely to be associated with which of the following?

    a. Routine transactions.

    b. Transactions with simple calculations.

    c. Accounting estimates with reliable measurements.

    d. Transactions for which management specifies the accounting treatment.

22. Which of the following auditors has correctly assessed control risk?

    a. Alex identifies risk without obtaining an understanding of internal control.

    b. Julie defaults to a control risk of high on every engagement.

    c. Reggie's assessment of control risk is based on an assertion's controls.

    d. Tia obtains an understanding of internal control based on inquiries before assessing control risk.

23. When performing a governmental audit, the auditor's responsibilities in relation to fraud are likely to be—
    a. greater than in other audits.
    b. less than in other audits.
    c. the same as in other audits.
    d. limited to the risks of material misstatement in the financial statements.
24. Which of the following statements best describes the consideration of fraud conditions?
    a. There are seven different conditions that may be present when fraud occurs.
    b. All of the fraud conditions must be found before concluding there are fraud risks.
    c. Fraud conditions often relate to observed attitudes or rationalizations.
    d. The nature of fraud conditions is typically unrelated to the type of risk.
25. Oversight by a governing body would be considered what in relation to fraud risk?
    a. A mitigating factor.
    b. A fraud condition.
    c. A fraud risk factor.
    d. A presumption of fraud risk.
26. Confirming receivables is considered which of the following?
    a. A limited procedure.
    b. A basic procedure.
    c. An extended procedure.
    d. A specified risk procedure.
27. Per AU-C 300B.09, the detailed audit plan includes all of the following **except:**
    a. A description of the nature and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
    b. A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure.
    c. A description of the nature, timing, and extent of planned further audit procedures at the financial statement level.
    d. A description of other audit procedures planned to be carried out for the engagement in order to comply with GAAS.

28. Which of the following statements most accurately describes the use of substantive procedures in the audit of a governmental entity?

    a. If risk assessment procedures and tests of controls provide sufficient appropriate audit evidence, substantive procedures are unnecessary.

    b. If auditors are able to assess the risks of material misstatement as low for a relevant assertion, substantive procedures are no longer required.

    c. Auditors are required to design and perform substantive procedures for each material class of transactions, account balance, and disclosure for all relevant assertions.

    d. Substantive analytical procedures are required instead of tests of details when risks related to relevant assertions are assessed as significant risks.

29. If the quantity of audit evidence obtained is enough to support the auditor's opinion, the audit evidence is deemed to be what?

    a. Appropriate.

    b. Effective.

    c. Reliable.

    d. Sufficient.

30. When would substantive analytical procedures be more appropriate than tests of details?

    a. Risks of material misstatement, including those related to fraud, are high.

    b. A transaction class fluctuates irregularly over the course of the financial period.

    c. An account balance has a low volume of transactions over time.

    d. A transaction class is unaffected by a high degree of subjectivity.

31. When performing tests of details in a governmental engagement, which of the following will typically be more important?

    a. Tests of balances.

    b. Transaction testing.

    c. Testing transactions and balances are of equal importance.

    d. Auditors can choose what type of tests of details to emphasize.

32. What is the determining factor in whether a procedure is considered a test of controls or a test of transactions?

    a. The objective of the test performed and the nature of exceptions.

    b. Whether a transaction or a balance is being tested.

    c. Whether any exceptions are discovered during testing.

    d. Whether the testing includes inspection of documents.

33. Use of which of the following is at the auditor's discretion?
    a. Preliminary analytical procedures.
    b. Substantive analytical procedures.
    c. Overall review analytical procedures.
    d. Both preliminary and overall analytical procedures.
34. What is an auditor's first step to designing effective substantive analytical procedures in a governmental audit?
    a. Evaluating the government's budgetary process.
    b. Talking to the government's operating personnel.
    c. Asking management what data they use to monitor and identify risks.
    d. Identifying government comparables for analysis.
35. Which of the following statements best describes whether circumstances are good for using substantive analytical procedures?
    a. Governmental units are particularly ill-suited for the use of substantive analytical procedures.
    b. Substantive analytical procedures are typically better at testing for a government's overstatements than understatements.
    c. A government must have reliable data available if an auditor plans to use substantive analytical procedures.
    d. Substantive procedures should seldom be used as the primary source of assurance on governmental account balances.
36. What term is used to describe the expected degree of accuracy in an auditor's prediction of an amount or account balance?
    a. Precision.
    b. Predictability.
    c. Planning materiality.
    d. Performance materiality.
37. Which of the following would be considered an unusual or unexpected relationship?
    a. Revenues that meet their budgeted amounts.
    b. Large, one-time or miscellaneous revenues.
    c. Deferred amounts that match those from the prior period.
    d. Investment income results synonymous with market conditions.

38. What guidance applies to the identification and evaluation of significant differences?

    a. To be classified as significant, differences must meet the definition and threshold identified in the authoritative literature.

    b. Even if a difference is not considered significant, additional audit work is needed to determine whether the account balance is misstated.

    c. A range of 10% to one-third of performance materiality is often a good rule of thumb for determining whether a difference is significant.

    d. Corroboration is not generally needed to explain the nature and extent of significant differences.

39. Can auditors use audit evidence from prior periods when performing a governmental audit?

    a. Yes, the use of such evidence is always allowed.

    b. Yes, if agreed upon with management, such evidence can be used.

    c. Yes, but the use of such evidence is highly restricted.

    d. No, the use of such evidence is prohibited.

40. When auditing a small local government, performing interim substantive procedures will help with all of the following **except**:

    a. Audit efficiency.

    b. Spreading the workload evenly.

    c. Meeting deadlines.

    d. Dealing with critical issues.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Local Governments—Course 2—Important Considerations for Performing Governmental Audits (ALGTG212)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State/ZIP: ______________

Firm Phone: ______________________________ Firm Fax No.: ______________

Firm Email: ______________________________

Signature: ______________________________

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Birth Month: ______________________________ Licensing State: ______________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this:

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
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.	○	○	○	○

You may complete the exam online for $109 by logging onto our Online Grading Center at **cl.tr.com/ogs.** Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com.* Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $109; the price for answer sheets sent by regular mail is $119.

Expiration Date: April 30, 2022

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Audits of Local Governments—Course 2—Important Considerations for Performing Governmental Audits (ALGTG212)

Your Name (optional): ____________________ Date: ____________________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this: ● not like this: ⦶ ⊗ ✓

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
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):

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3. What other courses or subject areas would you like for us to offer?
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GLOSSARY

Analytical procedures: Evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data. They include trend analysis, ratio analysis, and predictive or reasonableness tests.

Appropriateness: The measure of the quality of audit evidence (i.e., its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based).

Assertions: Representations made by management (explicit or otherwise) that are embodied in the financial statements and used by the auditor to consider the different types of potential misstatements that could occur. They fall into two categories: (1) assertions about classes of transactions and events, and related disclosures, for the period under audit and (2) assertions about account balances, and related disclosures, at period end.

Audit risk: The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of the *risk of material misstatement* and *detection risk*.

Capital projects funds: These account for and report financial resources restricted, committed, or assigned to be expended for capital outlay. These are one type of governmental category fund.

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

Component units: These are defined as (1) units for which the *primary government* is financially accountable; (2) units for which the primary government owns a majority of the equity interest; and (3) units that must be included to keep the financial statements from being misleading because of the nature or significance of their relationships with the primary government. This is part of the *governmental financial reporting entity*.

Custodial funds: These account for fiduciary activities that are not required to be reported in the other fiduciary fund types. These are one type of fiduciary category fund.

Debt service funds: These account for and report financial resources restricted, committed, or assigned to be expended for principal and interest. These are one type of governmental category fund.

Detection risks: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Enterprise funds: These may be used to account for any activity in which a fee is charged to an external user for goods or services. However, they *must* be used to account for activities (1) that are financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; (2) when laws or regulations require that the activity's costs of providing services, including capital costs, such as depreciation or debt service, be recovered with fees and charges (not taxes); or (3) the pricing policies of the activity establish fees and charges designed to recover its costs. These are one type of proprietary category fund.

External confirmation: A direct response to the auditor from a third party either in paper form or by electronic or other means, such as through the auditor's direct access to information held by a third party.

Fund: According to the GASB, this is a fiscal and accounting entity with a self-balancing set of accounts that record cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated to carry on specific activities or attain certain objectives in accordance with special regulations, restrictions, or limitations.

General fund: This fund accounts for and reports all financial resources except those accounted for and reported in other funds. A governmental unit reports just one general fund. This is one type of governmental category fund.

General government: One which provides a range of services.

Governmental financial reporting entity: This is made up of the *primary government* and *component units*.

Governmental organizations: As listed in SLG, these include all public corporations and bodies corporate and politic and other organizations that have any of the following characteristics: (1) officers of the organization are elected by popular vote, (2) a controlling majority of the organization's officers are appointed by officials of one or more state governments, (3) a government could unilaterally dissolve the organization and retain the organization's remaining net assets, or (4) the organization has the power to levy taxes (including being able to enact and enforce the levy).

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

Internal service funds: These account for the financing of goods or services provided by one governmental department or agency to another on a cost-reimbursement basis. These are one type of proprietary category fund.

Investment trust funds: These account for the external portion of a sponsoring governmental unit's investment pool. These are one type of fiduciary category fund.

Linkage: The relationship between assessed risks and further audit procedures. It is considered *clear linkage* if the further audit procedures are demonstrably responsive to the assessed risks.

Overall review analytical procedures: These are used in the final review stage of the audit.

Pension (and other employee benefit) trust funds: These typically account for a government's single-employer public employee retirement plan, other postemployment benefit plan, or other employee benefit plan. These are one type of fiduciary category fund.

Permanent funds: These account for and report resources that are restricted to allow the earnings (and not principal) to be used to support the government's programs, such as cemeteries, libraries, parks, or scholarships. These are one type of governmental category fund.

Preliminary (planning) analytical procedures: These are used to enhance the auditor's understanding of the governmental unit and assist in assessing areas of specific risk of misstatement by identifying unexpected relationships among account balances or the absence of expected relationships.

Primary government: This can be (1) a state government or general purpose local government (municipality or county); (2) a special purpose state or local government (e.g., school district, park district) that has a separately elected governing body, is legally separate, and is fiscally independent of other governments; or (3) when the primary government includes all of its funds, organizations, agencies, departments, institutions, and offices that make up the legal entity. It is part of the *governmental financial reporting entity*.

Private-purpose trust funds: These account for trust arrangements under which principal and income benefit individuals, private organization, or other governments, such as escheat property held in trust for the benefit of individuals or other governments. These are one type of fiduciary category fund.

Public corporation: A municipality or a governmental corporation that has been created to administer public affairs or as an instrumentality of the state, founded and owned in the public interest (e.g., states, cities, parishes, school districts, or special districts).

Risk of material misstatement: The risk that the financial statements are materially misstated prior to the audit. It consists of *inherent risk* and *control risk*.

Special purpose framework: This is a basis of accounting other than generally accepted accounting procedures (GAAP). Examples include the cash basis, the regulatory basis, the tax basis, the contractual basis, and an other basis.

Special purpose government: A legally separate entity that performs only one (or a few) specific activities (e.g., school districts, utilities, and public employee retirement systems).

Special revenue funds: These account for and report the proceeds of specific revenue sources that are restricted or committed for specified purposes other than debt service or capital projects. A special revenue fund should not be reported unless its foundation is one or more specific restricted or committed revenues. These are one type of governmental category fund.

Sufficiency: The measure of the quantity of audit evidence.

Substantive analytical procedures: These are used to obtain audit evidence about potential misstatements.

Substantive procedures: Further audit procedures performed for the purpose of detecting material misstatements at the relevant assertion level. They consist of tests of details and substantive analytical procedures.

Synthesis: Auditors' application of professional judgment to determine whether information gathered during the risk assessment process, either individually or in the aggregate, indicates where the entity's financial statements might be susceptible to material misstatement (whether due to error or fraud).

Tests of balances: These are tests applied directly to the details of balances in general ledger accounts (e.g., confirming the balances of accounts in the service accounts receivable subsidiary ledger with individual customers).

Tests of transactions: These are tests of individual transactions by obtaining supporting evidence of the transaction, such as inspection of the documents and accounting records involved in processing (e.g., inspecting supporting documents for a cash disbursement).

INDEX

This index is a list of general topics discussed in the course. More specific key word searches can be performed using the search feature of this PDF.

COMPANION TO PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS

COURSE 3

CONCLUDING THE AUDIT (ALGTG213)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses concluding the audit of a local government. Lesson 1 looks at general audit procedures applied during an audit (other than those related to specific financial statement elements). Lesson 2 covers other parts of completing the audit, such as considering the accumulated results of audit procedures, performing analytical procedures in the final stage of the audit, reviewing workpapers, and other summarizations and evaluations. Lesson 3 discusses drafting the financial statements and auditor's report, communications made at the conclusion of the audit, management letters, ESMs, and discovery of matters after the report date.
PUBLICATION/ REVISION DATE:	April 2021
RECOMMENDED FOR:	Users of *PPC's Guide to Audits of Local Governments*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of governmental 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*. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's *Government Auditing Standards*.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by **April 30, 2022**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—General Audit Procedures

Completion of this lesson will enable you to:

- Identify authoritative literature related to concluding the audit and general procedures for commitments, contingencies, litigation, claims, and assessments.
- Identify general procedures for subsequent events review, related party transactions, going concern, accounting estimates, and obtaining written representations.

Lesson 2—Additional Steps for Completing the Audit

Completion of this lesson will enable you to:

- Identify steps for considering accumulated results of audit procedures, analytical procedures in concluding the audit, and reviewing workpapers.
- Recognize issues on uncorrected misstatements and evaluating accumulated results of audit procedures.

Lesson 3—Drafting, Communication, and Subsequent Discoveries

Completion of this lesson will enable you to:

- Identify requirements for drafting the financial statements and auditor's report, and communicating internal control related matters.
- Assess issues related to communicating with those charged with governance, communication of fraud and violations of laws and regulations, requirements for preparing management letters and the ESM, and courses of action for subsequent discovery of matters after the report date.

TO COMPLETE THIS LEARNING PROCESS:

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ADMINISTRATIVE POLICIES

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Lesson 1: General Audit Procedures

INTRODUCTION

In addition to the audit procedures for specific financial statement elements, such as cash, revenue, etc., some other procedures are necessary that are more general in nature. The general and concluding procedures discussed in this course are as follows:

- Procedures to search for *commitments and contingencies*, including obtaining lawyers' letters.
- Obtaining written representations from governmental officials in a *management representation letter*.
- Procedures to search for *subsequent events* that occur after the statement of net position date, but that should be adjusted for or disclosed in the financial statements.
- Procedures to identify and evaluate the measurement and disclosure of *related party transactions*.
- Evaluation of whether there is a substantial doubt about the governmental unit's ability to continue as a *going concern* for a reasonable period of time.
- Procedures to identify and evaluate the measurement and disclosure of *estimates and fair value*.
- Performing *analytical procedures* as an overall review of financial information.
- *Reviewing workpapers* and the considerations related to *summarizing and evaluating* audit findings.
- *Drafting the financial statements and the auditor's report*.
- *Communicating internal control related matters* noted during the audit to appropriate parties.
- *Communicating certain matters related to the audit* to those charged with governance.
- *Communicating possible fraud and noncompliance* to those charged with governance and others, as appropriate.

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 opinions on the financial statements, and communicate those opinions and other significant matters in written and oral reports. The auditor is also subject to certain requirements for workpaper completion, 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.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify authoritative literature related to concluding the audit and general procedures for commitments, contingencies, litigation, claims, and assessments.
- Identify general procedures for subsequent events review, related party transactions, going concern, accounting estimates, and obtaining written representations.

Authoritative Literature

The authoritative pronouncements that establishes requirements or provide suggestions that most directly affect the general procedures, include the following:

a. AU-C 501B, *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 540B, *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 560B, *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.

e. AU-C 570B, *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 580B, *Written Representations*, requires that the auditor obtain certain representations from management.

g. GASBS No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, incorporates into GASB standards certain accounting and financial reporting guidance on related party transactions, going concern considerations, and subsequent events that had previously been presented only in GAAS.

h. GASBS No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, incorporates into GASB standards certain accounting and financial reporting guidance that had become nonauthoritative as a result of the FASB Codification.

i. *Government Auditing Standards* establishes additional requirements related to obtaining management representations, reviewing workpapers, evaluating noncompliance, and considering waste and abuse.

j. AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), provides guidance on accounting and financial reporting for state and local governments as well as application of GAAS to audits of financial statements of state and local governments. Among other things, SLG discusses management representations, legal letters, financial statement audit considerations, and communication of internal control related matters.

k. AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), discusses the auditor's responsibility for performing audits under *Government Auditing Standards* and OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance).

The authoritative pronouncements that establish requirements or that provide suggestions that most directly affect the aspects of concluding the audit described in the introductory paragraphs above are as follows:

a. Review, summarization, and evaluation:

   (1) AU-C 220B, *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 230B, *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. It also establishes requirements for documenting the auditor's review and finalizing and retaining audit workpapers.

   (3) AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud. It also includes requirements for the evaluation of audit findings for indication of possible fraud and for communications with client management.

(4) AU-C 250B, *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 300B, *Planning an Audit*, establishes broad requirements for review of the work of assistants.

(6) AU-C 330B, *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 450B, *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 520B, *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 260B, *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 265B, *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 700B, *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.

d. Workpaper completion, finalization, and retention:

(1) AU-C 230B, *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 560B, *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 585B, *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.

The AICPA has recently issued a series of auditing standards affecting pronouncements that establish requirements related to concluding the audit:

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, a suite of auditor reporting standards. SAS No. 134 supersedes and replaces the extant guidance AU-C 700B, AU-C 705B, and AU-C 706B; adds AU-C 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, and amends a number of other AU-C sections.
- SAS No. 135, *Omnibus Statement on Auditing Standards—2019*, whichresulted from the evaluation of three auditing standards that have been issued by the Public Company Accounting Oversight Board (PCAOB) since the AICPA's Auditing Standards Board (ASB) completed its auditing standards clarity project. The SAS amends 13 sections of the Statements on Auditing Standards.

- SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, which supersedes AU-C 720B, *Other Information in Documents Containing Audited Financial Statements*. The superseded auditing standard is now codified in AU-C 720B and SAS No. 137 is codified in AU-C 720
- SAS No. 138, *Amendments to the Description of the Concept of Materiality*, which changes the description of materiality so that it is more closely aligned with those of the United States judicial system, SEC, PCAOB, and Financial Accounting Standards Board.
- SAS No. 139, *Amendments to AU-C Sections 800,805, and 810 to Incorporate Auditor Reporting Changes from SAS No. 134*. See *PPC's Guide to Auditor's Reports* for further discussion.
- SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS No. 134 and 137*, to conform AU-C 725, 730, 930, 935, and 940 to the requirements of SAS No. 134 and SAS No. 137.

The AICPA issued SAS No. 141, *Amendment to the Effective Dates of SAS Nos. 134–140*, to defer the effective dates of SAS Nos. 134 through 140 for one year and to permit early implementation of all of these SASs. (SAS No. 141 is effective upon issuance.) The revised effective dates are for audits of financial statements for periods ending on or after December 15, 2021.

The AICPA issued SAS No. 142, *Audit Evidence*, which is now codified at AU-C 500, supersedes current guidance now codified at AU-C 500A (or AU-C 500B prior to amendments in SAS Nos. 134 through 141), moves guidance on the use of management specialists to AU-C 501, and amends various other AU-C sections. Key areas of change or potential improvement in audit quality covered by SAS No. 142 and amendments include use of automated tools and techniques, corroborative and contradictory information, conscious and unconscious bias, use of external information sources and the nuances of reliability of information as audit evidence. (Auditors may use automated tools and techniques before implementation of SAS No. 142.) SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. Due to the delayed effective date, this course does not fully incorporate SAS No. 142.

The AICPA issued SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. SAS No. 143 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. The standard retains the familiar requirement that the auditor's further procedures should include one or more of three approaches: (a) obtain evidence from events occurring up to the audit report date, (b) test how management made the estimate, or (c) develop the auditor's own point estimate or range. The new SAS adds requirements and guidance regarding assessment of risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting estimates. SAS No. 143, which is now codified at AU-C 540, supersedes *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is now codified at AU-C 540A (or AU-C 540B prior to amendments in SAS Nos. 134 through 141), and amends various other AU-C sections. SAS No. 143 is effective for audits of financial statements for periods ending on or after December 15, 2023. Due to the delayed effective date, this course does not fully incorporate SAS No. 143.

Specific changes made by these new SASs are described in this course in relation to the guidance they affect. Authoritative pronouncements that affect general procedures are explained in Lesson 1. Authoritative pronouncements that address the aspects of concluding the audit are explained in Lessons 2 and 3.

PROCEDURES RELATED TO 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 the presentation or disclosure matters for the assertions of related classes of transactions, events, or account balances.

Accounting Standards

Commitments. Commitments of a governmental unit are usually long-term contractual obligations with suppliers for future purchases at specified prices and sometimes specified quantities, contracts for construction projects, commitments under noncapitalized operating leases, and other significant commitments. The nature of significant commitments should be disclosed in the notes to the financial statements.

Contingencies. For contingencies, the proper accounting treatment depends on the likelihood (probable, reasonably possible, or remote) that a future event will confirm that a gain or loss has occurred and on the ability to make a reasonable estimate of the outcome. For the government-wide financial statements and proprietary funds, a loss contingency is accrued if 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, and the amount of the loss is reasonably estimable. If an accrual is not made for a loss contingency because one or both of these conditions are not met, but there is a *reasonable possibility* that a loss may have been incurred, the financial statements must disclose the nature of the contingency and must give an estimate of the loss or range of loss or state that such an estimate cannot be made. Disclosure of unasserted claims is necessary only if an underlying event has occurred indicating a potential loss or liability, it is probable that a claim will be asserted, and it is reasonably possible that the outcome would be unfavorable if the claim were asserted. Gain contingencies may need to be disclosed but should not be accrued.

Governmental funds follow the same criteria discussed in the previous paragraph for determining the need to accrue and disclose contingencies, but the manner in which accruals are recorded differs. GASBI No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*, clarifies the accounting by governmental funds for contingent liabilities for claims and judgments. It explains that liabilities for claims and judgments should be recognized as governmental fund liabilities to the extent that they mature each period. In other words, an expenditure (and a liability of equal amount) caused by a loss contingency would be accrued. Because governmental fund balance sheets reflect current liabilities, generally only the current portion of the liability should be reported in the fund. The remainder of the liability should be reported as a long-term liability in the government-wide financial statements. When a contingent liability is accounted for in this way, the financial statements should disclose the total amount of the loss contingency that met the accrual criteria, the amount reported as a fund liability and expenditure, and the portion that is recorded as a general long-term liability in the government-wide financial statements. The following paragraphs mention selected GASB Statements that discuss contingencies. Other GASB statements should also be considered.

GASBS No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, provides guidance on accounting and financial reporting for claims liabilities and expenditures or expenses.

GASBS No. 16, *Accounting for Compensated Absences*, provides guidance on accounting and financial reporting for compensated absences.

GASBS No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, provides guidance on accounting and financial reporting for governmental units that own or operate municipal landfills.

GASBS No. 47, *Accounting for Termination Benefits*, provides guidance on accounting and financial reporting for all termination benefits. Previous guidance addressed only voluntary "special" termination benefits—generally those offered to employees for a limited period of time.

GASBS No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, provides guidance on accounting and financial reporting for a government's obligation to address the current or potential detrimental effects of existing pollution. Under GASBS No. 49, if one of any five specific events occurs a government is required to estimate expected pollution remediation outlays and determine whether they should be recorded as a liability or capitalized.

GASBS No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, incorporates the text of the pre-November 30, 1989, FASB, APB, and ARB pronouncements that the GASB considers to be applicable to state and local governments (that is, are relevant to governments and do not conflict with or contradict GASB pronouncements), including the SFAS No. 5 guidance on contingencies. GASBS No. 62 guidance related to contingencies is limited to the following kinds of events:

- Collectability of receivables.
- Guarantees of indebtedness of others.
- Agreements to repurchase receivables (or related property) that have been sold.
- Claims for delays or inadequate specifications on contracts.

GASBS No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, prescribes the accounting and financial reporting for both—

- governments that extend, without receiving consideration, a guarantee of a financial obligation of another legally separate entity to indemnify a third party if the issuer of the obligation fails to fulfill its payment requirement under the obligation; and
- governments that issue debt that has been guaranteed by another legally separate entity without providing consideration.

When qualitative factors and historical data indicate that it is more likely than not that the guarantor government will be required to make a payment related to the nonexchange financial guarantees it extended, the government should recognize a liability equal to the estimated present value of the future outflows expected to be incurred as a result of the guarantee. Specific information about the guarantee should also be disclosed.

GASBS No. 83, *Certain Asset Retirement Obligations*, provides guidance on accounting and financial reporting for certain asset retirement obligations (AROs). Governmental units that have a legal obligation to perform future asset retirement activities related to its tangible capital assets should recognize a liability and a corresponding deferred outflow of resource when the obligation is incurred and reasonably estimable.

GASBS No. 91, *Conduit Debt Obligation*, clarifies the definition of conduit debt obligations and eliminates the option to report conduit debt as the governmental unit's own liability. GASBS No. 91 indicates that all issuers make limited commitments related to conduit debt obligations to maintain their tax-exempt status. Some issuers may make additional commitments, including moral obligation pledges, appropriation pledges, financial guarantees, and asset or revenue pledges as security. In addition, an issuer may voluntarily make a debt service payment if the third-party obligor is unable to do so. Issuers do not record a liability for conduit debt obligations unless it is more likely than not that the issuer will make one or more debt service payments associated with its additional or voluntary commitments. An issuer with only limited commitments is required to perform a more likely than not assessment when an event or circumstance causes it to consider making a voluntary debt service payment. An issuer with additional commitments is required to perform an annual assessment of qualitative factors to determine if it is more likely than not that it will make a debt service payment.

GASBS No. 94, *Public-Private and Public-Public Partnerships and Availability Payment Arrangements*, expands and supersedes the guidance applied to service concession arrangements in GASBS No. 60, and provides guidance for transferors or operators to recognize underlying assets, deferred outflows or inflows of resources, receivables and liabilities associated with these partnerships.

GASBS No. 96, *Subscription-Based Information Technology Arrangements*, provides additional guidance for the recognition of contracts that allow a government to use information technology assets owned by a third-party vendor in exchange for a series of subscription payments. GASBS No. 96 applies the concepts of GASBS No. 51 for intangible assets, and the long-term lease concepts of GASBS No. 87.

It is important to consider which fund should record a contingent liability that has been incurred and the amount of the liability that should be reported. Suppose, for example, that a city is sued by a citizen who was hit by a city sanitation truck. The general fund would probably pay any resulting liability because that fund usually accounts for a city's sanitation services. The auditor needs to consider the timing of payment of the liability to determine whether the contingency was properly reported in the general fund and in the government-wide financial statements. The authors believe that a fund liability and related expenditure should be recorded at the balance sheet date if the claim will be paid in the next period; e.g., a claim or judgment that is payable on demand. In some cases, it is likely that some or all of the liability will not be paid until after the next period; e.g., extended payment agreements for litigation claims or compensated absences. In those cases, it is reasonable to accrue a fund liability and related expenditure only for the current portion and record the remainder as a long-term liability in the government-wide financial statements.

Audit Procedures

Audit procedures are initially directed at determining the existence of commitments and contingencies so that valuation and disclosure can be considered. They may be difficult to find because they may not be recorded. The auditor may be aware of possible commitments or contingencies from knowledge of the governmental unit's activities and operating characteristics. Some commitments or contingencies may be discovered as a result of audit procedures applied to specific financial statement components. For example, commitments to purchase materials or supplies may be identified in applying audit procedures to inventory, or lease commitments may be noted during the audit of rent and other lease payments.

Other audit procedures that are often used to search for commitments and contingencies include the following:

- Inquiring of responsible officials about the possibility of unrecorded commitments or contingencies. See the discussion later in this lesson regarding inquiries related to commitments and contingencies performed during the subsequent events review.
- Reading minutes of meetings of the governing body; e.g., city council.
- Reading contracts, debt agreements, leases, and similar documents.
- Reviewing current and past years' reports from grantor agencies, if any.
- Reviewing legal expenses and invoices and correspondence from lawyers.
- Reviewing communications from regulatory agencies such as the Environmental Protection Agency or similar federal or state agencies.
- Reviewing transactions subsequent to the statement of net position date.
- Sending a letter of inquiry to legal counsel.

Some commitments and contingencies stem from financing transactions or arrangements with financial institutions; e.g., 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 governmental unit'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 responsible officials and the governmental unit's legal counsel. According to AU-C 501B.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. This subject is discussed in the following section.

DEALING WITH LITIGATION, CLAIMS, AND ASSESSMENTS

Introduction and Authoritative Literature

AU-C 501B, *Audit Evidence—Specific Considerations for Selected Items*, among other topics, provides guidance for identifying an entity's litigation, claims, and assessments that may result in a risk of material misstatement. This guidance is found in paragraphs AU-C 501B.03, 501B.16–.24, and 501B.A39–.A65. Additionally, AU-C 501B.A69 provides an illustrative audit inquiry letter to legal counsel.

Inquiry of Legal Counsel

AU-C 501B.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 were discussed earlier. In a small governmental 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, AU-C 501B.20 states that the auditor should document the basis for that decision. It is important to note that when a lawyer's letter will be sent, the auditor must control the mailing and receipt of the letter as prescribed by professional standards.

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 concerning pending or threatened litigation:

a. The nature of the litigation.

b. The progress of the case to date.

c. How the governmental unit is responding or intends to respond to the litigation (for example, to contest the case or to seek 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 when the lawyer handling the litigation has evaluated the litigation in the aggregate in accordance with materiality limits specified by the auditor.

There are two approaches for 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. 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 governmental engagement, especially if the governmental unit does not have inside legal counsel.

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. This approach may be more efficient if the governmental unit has both inside and outside legal counsel. The inside legal counsel may be able to prepare the information and thus reduce the cost of obtaining the representations of outside legal counsel.

Materiality Limit in the Legal Request

Both of the letters include a specified materiality limit so that the lawyer knows what items are to be considered material, individually or in the aggregate, for purposes of the response. The materiality amount is generally some fraction of performance materiality computed in audit planning. In a governmental audit, performance materiality is computed for each opinion unit; and, for across-opinion unit testing, the smallest performance materiality amount for the opinion units being tested is used. This basic approach can be used to determine the materiality limit for the legal letter. If a letter is sent to a lawyer who only handles matters for a particular opinion unit a different amount for that opinion unit may be used. For example, a city's water and sewer or electric service that is accounted for in an enterprise fund may retain its own lawyer. In some cases, the governmental unit retains only one attorney. In that case, a materiality amount for the opinion units that could potentially be affected by litigation, claims, or assessments should be used. 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 and assessments 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 GAAP, 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 governmental 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 501B.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 501B.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

A small governmental unit may not retain inside or outside counsel or may not have consulted a lawyer during the period about litigation, claims, or assessments. In this case, the 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, the authors recommend that, in such a case, 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 U.S. 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.

Evaluating Lawyers' Response

The auditor needs to evaluate the lawyer's response to inquiries, making sure the response contains all items of information requested. The auditor also needs to evaluate the wording of the lawyer's assessment of the probability of an unfavorable outcome carefully. According to the ABA Statement of Policy on lawyers' letters (reprinted as Exhibit A to AU-C 501B), 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. Therefore, the auditor needs to decide whether the response is clear regarding a probable or remote outcome, since the need to accrue or disclose a loss contingency depends on such determination. Exhibit 1-1 presents examples of wording that is either clear or unclear based on guidance in AU-C 501B.A65.

Exhibit 1-1

Examples of Lawyers' Responses

Responses That Clearly Indicate an Unfavorable Outcome Is Remote

- "We are of the opinion that this action will not result in any liability to the governmental unit."
- "We believe that the plaintiff's case against the governmental unit is without merit."
- "We believe the governmental unit will be able to defend this action successfully."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the governmental unit in these suits."
- "It is our opinion that the possible liability to the governmental unit in this proceeding is nominal in amount."

Responses That Are Unclear on Likelihood of Outcome

- "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 governmental unit's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "We believe the action can be settled for less than the damages claimed."
- "We are unable to express an opinion as to the merits of the litigation at this time. The governmental unit believes there is absolutely no merit to the litigation."
- "In our opinion, the governmental unit has a substantial chance of prevailing in this action."
- "It is our opinion that the governmental unit will be able to assert meritorious defenses to this action."

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 Governmental Unit] 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 governmental unit 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 Governmental Unit].

According to AU-C 501B.A61, such comments in lawyers' letters are not limitations on the scope of their responses. Thus, those comments do not affect the auditors' evaluations.

In addition, some lawyers' responses emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments. They may reference Paragraph 5 of the American Bar Association Statement of Policy and indicate they cannot respond to general inquiries related to the existence of unasserted possible claims or assessments or comment on the adequacy of the client's listing, but can only comment on those unasserted possible claims or assessments for which the client in writing has specifically requested comment. AU-C 501B.A62 indicates such wording is not a limitation on the scope of the audit. However, the lawyer's response should confirm the client's understanding (based on Paragraph 6 of the ABA Statement of Policy) that the lawyer would advise and consult with the client concerning the client's obligation to make financial statement disclosures of unasserted possible claims or assessments.

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.

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 those conclusions provided by the legal counsel's oral response concerning the need to account for or disclose litigation, claims, and assessments.

Dating of Lawyers' 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, the authors recommend 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 501B.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 501B.22 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.

As explained earlier in this section, 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 501B.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. The authors believe that unless the auditor is able to obtain such confirmation, the matter does constitute a scope limitation.

As noted in AU-C 501B.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.

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 pieces of authoritative literature should auditors reference to obtain information regarding the general procedures to search for contingencies during an audit?
   a. AU-C 501B, *Audit Evidence—Specific Considerations for Selected Items*.
   b. AU-C 700B, *Forming an Opinion and Reporting on Financial Statements*.
   c. AU-C 260B, *The Auditor's Communication with Those Charged with Governance*.
   d. AU-C 220B, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*.
2. Which of the following governments has correctly accounted for a commitment or a contingency?
   a. Government A discloses the nature of all its major and minor commitments in the notes to the financial statements.
   b. Government B discloses and accrues its significant gain contingencies.
   c. Government C only discloses loss contingencies related to the proprietary fund if it is probable that they will occur.
   d. Government D includes the current portion of a loss contingency in a governmental fund balance sheet rather than the entire amount.
3. Which of the following auditors has correctly dealt with an issue related to the legal letter?
   a. Sonny uses a legal letter dated two months before his auditor's report.
   b. Albert documents the oral response he received about legal matters covered by the audit inquiry letter.
   c. Eric's client has not consulted a lawyer, so he obtains no written representations from management regarding litigation or claims.
   d. Skip uses a legal letter in which the client's counsel limited the response to cases in which ten or more hours were billed.

SELF-STUDY ANSWERS

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

1. Which of the following pieces of authoritative literature should auditors reference to obtain information regarding the general procedures to search for contingencies during an audit? **(Page 329)**

   a. **AU-C 501B, *Audit Evidence—Specific Considerations for Selected Items*. [This answer is correct. This pronouncement identifies the procedures to search for contingencies and establishes requirements for obtaining information from a client's lawyers. Procedures to search for commitments and contingencies, including obtaining lawyers' letters, are part of the general procedures that are performed during an audit.]**

   b. AU-C 700B, *Forming an Opinion and Reporting on Financial Statements*. [This answer is incorrect. This authoritative pronouncement specifies the auditor's responsibility to form an opinion on the financial statements and the content of the auditor's reports. This guidance affects reporting, which is an aspect of concluding the audit, not general procedures.]

   c. AU-C 260B, *The Auditor's Communication with Those Charged with Governance*. [This answer is incorrect. This pronouncement requires communication of certain matters to those charged with governance in an audit of financial statements. This is a required communication, which is an aspect of concluding the audit, not general procedures.]

   d. AU-C 220B, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*. [This answer is incorrect. This authoritative pronouncement 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. This guidance would be used in relation to review, summarization, and evaluation, which are aspects of concluding the audit, not general procedures.]

2. Which of the following governments has correctly accounted for a commitment or a contingency? **(Page 333)**

   a. Government A discloses the nature of all its major and minor commitments in the notes to the financial statements. [This answer is incorrect. The nature of *significant* commitments should be disclosed in the notes to the financial statements. Therefore, Government A does not need to include the minor (insignificant) commitments in this disclosure.]

   b. Government B discloses and accrues its significant gain contingencies. [This answer is incorrect. Gain contingencies may need to be disclosed but should not be accrued.]

   c. Government C only discloses loss contingencies related to the proprietary fund if it is probable that they will occur. [This answer is incorrect. For the government-wide financial statements and proprietary funds, a loss contingency is accrued if 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, and the amount of the loss is reasonably estimable. If an accrual is not made for a loss contingency because one or both conditions are not met, but there is a *reasonable possibility* that a loss may have been incurred, the financial statements must disclose the nature of the contingency and must give an estimate of the loss or range of loss or state that such an estimate cannot be made. Therefore, Government C also needs to address the contingencies that are reasonably possible.]

   d. **Government D includes the current portion of a loss contingency in a governmental fund balance sheet rather than the entire amount. [This answer is correct. According to GASBI No. 6, liabilities for claims and judgments should be recognized as governmental fund liabilities to the extent that they mature each period. In other words, an expenditure (and a liability of equal amount) caused by a loss contingency would be accrued. Because governmental fund**

balance sheets reflect current liabilities, generally only the current portion of the liability should be reported in the fund. The remainder of the liability should be reported as a long-term liability in the government-wide financial statements.]

3. Which of the following auditors has correctly dealt with an issue related to the legal letter? **(Page 339)**

   a. Sonny uses a legal letter dated two months before his auditor's report. [This answer is incorrect. 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. If the lawyer's response is dated too long before the date of the auditor's report (which is the case for Sonny's audit engagement), the auditor needs to consider getting an updated response.]

   b. **Albert documents the oral response he received about legal matters covered by the audit inquiry letter. [This answer is correct. It is permissible for the auditor to obtain an oral response concerning matters covered by the audit inquiry letter. If this occurs, the auditor should document conclusions reached and the basis for those conclusions provided by the legal counsel's oral response concerning the need to account for or disclose litigation, claims, and assessments. Therefore, Albert has correctly dealt with receiving an oral response instead of a written response in this engagement.]**

   c. Eric's client has not consulted a lawyer, so he obtains no written representations from management regarding litigation or claims. [This answer is incorrect. A small governmental unit may not retain inside or outside counsel or may not have consulted a lawyer during the period about litigation, claims, or assessments. In this case, the 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, in such a case, it would be a best practice to modify the written representation obtained from management as it relates to litigation, claims, and assessments to say that management is not aware of any that need to be accrued or disclosed in the financial statements and has not consulted a lawyer. Therefore, it would not be adequate for Eric to obtain no representation about litigation, claims, and assessments under these circumstances.]

   d. Skip uses a legal letter in which the client's counsel limited the response to cases in which ten or more hours were billed. [This answer is incorrect. 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 (e.g., Skip) will generally need to ask the client to have the attorney respond based on the materiality limits specified in the original request.]

THE SUBSEQUENT EVENTS REVIEW

Definitions

AU-C 560B, *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 (Lesson 3 discusses the objectives and requirements relating to the auditor's responsibilities for subsequent discovery of matters after the date of the auditor's report). GASBS No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, includes accounting and disclosure standards for subsequent events.

Events or transactions that affect the financial statements and that occur subsequent to the statement of net position date, but before the financial statements are issued, are called subsequent events. GASBS No. 56 describes the following two types of subsequent events:

- Recognized Events—events that provide additional evidence with respect to conditions that existed at the date of the statement of net position and affect the estimates inherent in the process of preparing the financial statements. All information that becomes available prior to the issuance of the financial statements should be used in evaluating the conditions on which the estimates are based, and the financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

- Nonrecognized Events—events that provide evidence with respect to conditions that did not exist at the date of the statement of net position but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that their disclosure is essential to a user's understanding of the financial statements.

The distinction between the two types of subsequent events is highlighted by the classic example of a water utility that suffers a loss from an uncollectible account receivable of a major customer due to a bankruptcy in the subsequent period. The key is whether the condition causing the bankruptcy occurred before or after the date of the statement of net position. If the bankruptcy was the result of deteriorating financial conditions that began before that date, it is a recognized event and the financial statements should be adjusted. If the loss resulted from the customer's major casualty, such as a fire or flood, after that date, it is a nonrecognized event and should be disclosed without adjustment.

Subsequent events affecting the realization of assets or the settlement of estimated liabilities ordinarily require adjustment because they typically represent the culmination of conditions that existed over a long period of time. However, changes in the quoted market price of securities typically reflect new conditions and should not result in adjustment. Other examples of nonrecognized events that should be disclosed, but not adjusted for, include creation of a new component unit, the loss of a government facility as a result of a natural catastrophe, or the issuance of bonds.

The reporting of subsequent events should be evaluated in relation to the individual opinion unit affected by the event (SLG, Paragraph 15.38). Examples of common subsequent events in a governmental engagement that require disclosure are as follows:

- Filing or settlement of a lawsuit.
- Issuance or defeasance of bonds or other material debt.
- Award and acceptance of a grant.
- Loss of grant funding or notice of potential disallowances.
- Changes in activities or amounts included in the subsequent budget.
- Imposition of unfunded mandates.
- Change in the property tax base.

- Decline in value of investment portfolios.
- Renegotiated labor contracts.
- Impairment of capital assets by fire, flood, or other disaster.

COVID-19 Subsequent Events Review Considerations

COVID-19 has disrupted most aspects of life around the world and has many implications for auditing, including requirements related to the auditor's evaluation of subsequent events. To help auditors identify and address those implications, the authors recommend auditors review a checklist or practice aid, such as those provided in *PPC's Guide to Audits of Local Governments*, during the planning, risk assessment, and concluding phases of the audit and utilize them as a reference tool throughout the engagement.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to cover COVID-19-related audit issues in a general way. However, the GASB, AICPA, and other organizations have provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the resulting accounting and auditing issues. The resources can be found at **https://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174469582**, **https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center**, **https://www.gfoa.org/coronavirus**, and **https://checkpoint.riag.com/.**

Subsequent Events and Reissued Financial Statements

In cases where financial statements have been reissued, or are reissued in comparative form with financial statements of subsequent periods, events that have occurred since the original date of issue may require disclosure if they are considered essential to the user's understanding of the financial statements. These events will result in an adjustment of the financial statements only if the adjustment meets the criteria for the correction of an error or a prior period adjustment.

Subsequent Events Discussion in MD&A

Paragraph 11(h) of GASBS No. 34 requires that currently known facts, decisions, or conditions that are expected to have a significant effect on the government's financial position or results of operations be discussed as part of Management's Discussion and Analysis (MD&A). Further, GASBS No. 56 states that, depending on the facts and circumstances, a discussion of subsequent events in MD&A may be necessary.

Subsequent Events Review Procedures

Some subsequent events may be discovered as a result of audit procedures applied for specific financial statement elements. These procedures usually involve cutoff tests and assessment of valuation. For example, the inspection of subsequent collections of receivables may disclose a material subsequent event. However, there is a group of procedures performed specifically to search for material subsequent events.

According to AU-C 560B.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; therefore, subsequent events review procedures need to be performed up through the date when the auditor has obtained sufficient evidence to support the opinion on the financial statements. In addition, it is ordinarily expected that the date of the auditor's report will 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.

The audit procedures specifically required by AU-C 560B.10 are limited to (a) obtaining an understanding of management's procedures for identifying subsequent events, (b) inquiries, (c) reading minutes, (d) reading the latest interim financial statements. In practice, auditors typically perform the following procedures:

a. *Understand Management's Procedures.* Auditors 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.* Auditor inquires about the current status of items that were accounted for based on preliminary or inconclusive data.

c. *Evaluate Evidence about Estimates.* Auditor considers whether events occurring up to the date of the auditor's report provide audit evidence about accounting estimates.

d. *Obtain Lawyer's Letter.* Letters obtained from the client's lawyers cover matters at the financial position statements date through a period specified in the audit inquiry letter that is as close as possible to the audit report date. (AU-C 501B.A53)

e. *Obtain a Management Representation Letter.* Written representations obtained from management should be as of the audit report date.

f. *Read Minutes of Governing Body Meetings.* Reading minutes should include those available for meetings after the financial position statements 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.* Reading 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 governmental unit, internal financial reports may not be extensive, and the auditor needs to discuss with management what information is used to monitor operations.

h. *Scan Journals and Ledgers.* Auditors scan accounting records for the subsequent period for unusual or significant items related to the current period.

i. *Consider Impairment of Assets.* Auditors consider whether the carrying amount of assets has become impaired subsequent to year end.

Additional procedures may be necessary to follow up on material subsequent events discovered in performing the above procedures. If material subsequent events are discovered, the auditor should ensure that the information needed to support adjustments to the financial statements or disclosures about subsequent events. (AU-C 560B.11)

AU-C 560.A6, as amended by SAS No. 135, suggests that inquiries may include specific inquiries about matters such as the following:

- New commitments, borrowings, or guarantees.
- Planned or executed disposals or acquisitions of assets.
- Agreements or plans to merge or liquidate.
- Appropriation of assets by a government.
- Destruction or extensive damage of assets such as by fire or flood.
- Developments concerning contingencies.
- Unusual accounting adjustments entered or considered.
- Events or potential events calling into question accounting policies, including the going concern assumption, or measurement of estimates.
- Changes in related parties.

- Significant new related-party transactions.
- Significant unusual transactions.

The last three above specific inquiries were added by SAS No. 135 as part of incorporation of material from PCAOB AS 2410, *Related Parties*, to heighten the auditor's focus on related-party relationships and transactions.

Consideration of Subsequent Events When Reporting on Supplementary Information

AU-C 725B, *Supplementary Information in Relation to the Financial Statements as a Whole*, provides guidance on the auditor's responsibilities when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. AU-C 725B.08 explains that the auditor has no responsibility for the consideration of subsequent events with respect to such supplementary information. However, if information comes to the auditor's attention (a) prior to the release of the auditor's report on the financial statements regarding subsequent events that affect the financial statements, or (b) subsequent to the release of the auditor's report on the financial statements regarding facts that, if known to the auditor at the date of the report, may have caused the auditor to revise the report, the auditor should apply the relevant requirements in AU-C 560B.

ISSUES INVOLVING RELATED PARTIES

Introduction and Authoritative Literature

In a governmental unit, as in a business enterprise, most transactions result from bargained dealing. When the parties to a transaction are related, the objectivity expected in unrelated bargaining may be lost. Because of this loss of objectivity, knowledge of the nature and volume of transactions with related parties may be necessary to understand the financial statements affected. Consequently, material related-party transactions should be disclosed. Related party considerations can be extremely important in a governmental engagement because of the adverse public reaction to publicity concerning transactions such as a city dealing with members of the city council.

In a governmental engagement, related parties include members of the governing body (city council, commissioners court, etc.); board members (board of education, zoning board, etc.); administrative officials (mayor, city manager, school superintendent, director of public works, etc.); immediate families of administrative officials, board members, and members of the governing body; and affiliated governmental units that are not included in the financial statements as part of the reporting entity such as metropolitan water and sewer systems, etc. Examples of related party transactions in a governmental engagement include buying janitorial supplies from a city council member's company, leasing a government-owned retail complex to the mayor, and selling city park land to a council member.

According to AU-C 550.A15, identifying a related party relationship and its appropriate treatment in the financial statements depends on the governmental entity's application of its financial reporting framework. In some cases, the governmental entity may have no legal jurisdiction over the related party even when the application of the financial reporting framework indicates that the governmental entity's financial statements should include those of the related party. Thus, the auditor should apply the concepts and guidance from the applicable financial reporting framework to formulate inquiries that will assist in making appropriate assessments about the existence and nature of related party relationships.

Accounting Standards. GASB Cod. Sec. 2250.102 requires that the financial statements disclose related party transactions other than compensation arrangements, expense allowances, and other similar items in the ordinary course of the governmental unit's operations. GASB Cod. Sec. 2250.107 provides that the disclosures should include—

- The nature of the relationship(s).
- A description of the transactions for each of the periods for which financial statements are presented, and other information deemed necessary to an understanding of the effects of the transactions on the financial statements (including transactions to which no amounts or nominal amounts were ascribed).

- The dollar amounts of transactions, for each of the periods for which financial statements are presented, and the effects of any change in the method of establishing the terms from that used in the preceding period.
- Amounts due from or to related parties as of the financial position statements date and, if not otherwise apparent, the terms and manner of settlement.

GASBS No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, provides additional guidance on accounting for related-party transactions. Its guidance emphasizes the critical importance of *substance over form*. When the involvement of related parties causes the substance of a particular transaction to be significantly different from its form, the financial statements should recognize the substance of the transaction rather than merely its legal form. Examples of transactions that have features that may indicate that a substance-over-form condition exists include the following:

- Making or receiving interest-free loans or loans on which the interest rate is significantly above or below prevailing market rates.
- Making loans that have no scheduled repayment terms.
- Selling real estate for an amount that is significantly different from the appraised value.
- A nonmonetary exchange of property for similar property.

Although interfund transactions are not generally considered related-party transactions, certain disclosures about such transactions and balances should be made. These include:

- Amounts transferred from and amounts due from other funds by individual major fund, nonmajor governmental funds in the aggregate, nonmajor enterprise funds in the aggregate, internal service funds in the aggregate, and fiduciary fund type.
- The purpose for interfund balances and transfers.
- Interfund balances not expected to be repaid within one year.
- The intended purpose and amount of significant transfers that either do not recur on a routine basis or are inconsistent with the activities of the fund making the transfer.

Related party disclosures generally should not imply that transactions were equivalent to arm's length because such representations usually cannot be substantiated. GASBS No. 56 observes that governments frequently enter into transactions and engage in activities that are driven by societal needs and concern for the "public good." As a result, comparison of governmental programs and arrangements to what might have occurred in an arm's-length transaction in the private sector may not be appropriate.

Auditing Standards. The auditor's responsibilities relating to related parties and related party transactions is contained in AU-C 550, *Related Parties*, and other related AU-C sections. SAS No. 135, issued in May 2019, amends the auditing standards to incorporate material from PCAOB AS 2410, *Related Parties*, including requirements related to significant unusual transactions. These amendments are intended to increase the auditor's focus on related parties relationships and associated transactions. The SAS enhances existing requirements to identify related parties or significant related party transactions that were previously unidentified or undisclosed. Also, the auditor's response to the risks of material misstatement relating to related parties relationships and associated transactions is enhanced by including procedures for testing the completeness and accuracy of related parties relationships and transactions.

Audit Procedures

Audit procedures for related-party relationships and transactions are applied at different times throughout the audit. At the start of the engagement, the auditor identifies obvious or known related parties and transactions (or updates information obtained in previous audits) to be kept in mind as other procedures are applied during the audit. Inquiry of predecessor auditors and governmental officials and review of organization charts, prior audit workpapers, minutes, contracts, agreements, pensions or similar trusts, etc., are sources of information about related parties and transactions. AU-C 550.A14, as added by SAS No. 135, suggests the inquiries about the governmental unit's related parties may include background information about the related parties (e.g., physical location, industry, size, and extent of operations). Since many governments require officials and employees to file disclosures of related party relationships and transactions, auditors could obtain information from those disclosures. Also, the auditor should consider obtaining representations from the senior administrative officials and governing body, such as the city administrator or mayor and the city council, about whether they or any other related parties engaged in any transactions with the governmental unit during the period.

Generally, the same audit procedures are applied to related party transactions as to other significant unusual transactions (vouching, confirmation, recomputation, etc.) to obtain reasonable assurance that the transactions do not contain misstatements that could be material to the financial statements. In some cases, reference to financial statements of the related party or application of audit procedures at the related party may be necessary to obtain evidence or understanding about the transaction. At the end of the audit, the auditor considers whether the results of procedures applied during the audit indicated the existence of related-party transactions that should be disclosed. The auditor's objective at the later stage is to understand the business purpose of the transactions and to consider whether transactions are occurring that are not being recognized in the accounting records.

SLG, Paragraph 15.19, indicates that because the auditor is required to evaluate whether the financial statements for each opinion unit achieve fair presentation, the auditor should evaluate whether identified related-party relations and transactions have been appropriately accounted for and disclosed, and whether any such relations and transactions prevent an opinion unit's financial statements from achieving fair presentation.

Substantiating Material Related-party Transactions. In addition to the procedures mentioned above, the auditor is required to perform procedures on balances with affiliated entities in accordance with AU-C 550.23, as amended by SAS No. 135. The auditor could also consider arranging for audits of inter-entity account balances at concurrent dates and examination of specified, important, and representative related party transactions by the auditors for each of the parties, with exchange of relevant information. An auditor needs to understand the business purpose of material related party transactions and recognize that proper authorization of such transactions, such as by management 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.A36. 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 management and those charged with governance about whether they or any other related parties engaged in any transactions with the entity during the period.

When significant unusual transactions are identified, the auditor should inquire of management about the nature of the transactions and whether related parties could be involved (AU-C 550.18).

Also, as previously discussed, management's disclosures about related-party transactions should not assert that the transactions were consummated on the equivalent of an arm's-length basis unless those representations can be substantiated. AU-C 550.A46 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.A47–.49 provides some example procedures that might be performed to substantiate such representations. If the representations cannot be substantiated, the auditor considers the implications for his or her opinion on the financial statements.

Related-party Transactions and Fraud. AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider fraud risk factors when assessing the risk of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate 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, as amended by SAS No. 135, lists the following risk factors that may involve transactions with related parties:

- Related-party transactions that are also significant unusual transactions.
- Significant related-party transactions with related entities that are either unaudited or audited by another firm.
- Assets, liabilities, revenues, or expenditures/expenses based on significant estimates that involve management's judgments.
- Significant or highly complex transactions, or significant unusual transactions (especially near period-end) that are difficult to assess for "substance over form."
- Significant operations located or conducted across jurisdictional borders where differing business environments exist.
- Overly complex organizational structure involving unusual legal entities, unusual managerial lines of authority, or contractual arrangements that appear to lack a clear business purpose.
- The exertion of dominant influence by or over a related party.
- Contractual arrangements lacking a business purpose.

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.A23 provides the following examples of such records or documents:

- Confirmations such as bank and legal confirmations.
- Information submitted to regulatory authorities.
- Conflict of interest statements from management or those charged with governance.
- Investment records of the governmental unit 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.
- Internal audit reports.
- Financing arrangements with entities other than financial institutions.
- Capital additions through economic development arrangements.

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 500B.A24 provides the following examples:

- Participating in unincorporated partnerships (e.g., joint ventures or shared services arrangements).
- Entering into agreements to provide services to parties on terms or conditions outside the normal course of business.
- Guarantees or guarantor relationships.

The authors believe the auditor ought to seek information about the other party to such arrangements or agreements and consider the business purpose. AU-C 550.A29 also observes that a related party could be involved in a significant unusual transaction by directly or indirectly influencing it through an intermediary.

Procedures should be performed to identify undisclosed related parties or to investigate potential related-party transactions if the auditor decides to modify his or her procedures based on the consideration of identified fraud risks. Additional procedures 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 550.24 requires that the auditor determine whether the underlying circumstances confirm their existence. If the auditor's procedures in fact identify such relationships or transactions, AU-C 550.25 indicates the auditor should:

- 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 procedures as necessary.
- Evaluate the implications for other aspects of the audit if management's nondisclosure of the relationships and transactions appears intentional.

CONSIDERATIONS RELATED TO GOING CONCERN

Accounting Considerations

GASBS No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, observes that continuation of a legally separate governmental entity as a going concern is assumed in financial reporting in the absence of evidence to the contrary. The standard clearly makes the financial statement preparer—not the auditor—primarily responsible for evaluating whether there is substantial doubt about a government's ability to continue as a going concern. GASBS No. 56, Paragraph 16 states that:

a. Financial statement preparers have a responsibility to evaluate whether there is substantial doubt about a government's ability to continue as a going concern for 12 months beyond the financial statement date.

b. If there is information that is currently known to the government that may raise substantial doubt shortly thereafter (for example, within an additional three months), it also should be considered.

AU-C 570B, *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. In May 2019, the AICPA issued SAS No. 134, *Auditor Reporting and Amendments Addressing Disclosure in the Audit of Financial Statements*. SAS No. 134 amends the requirements for the form and content of the audit report with respect to going concern matters but does not change the auditor's approach and procedures.

COVID-19 Going Concern Considerations. COVID-19 has disrupted most aspects of life around the world, and has many implications for auditing, including significant considerations for management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern. The authors recommend auditors review a checklist or practice aid of COVID-19-related factors during the planning, risk assessment, and concluding phases of the audit and utilize it as a reference tool throughout the engagement.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to cover COVID-19-related audit issues in a general way. However, the GASB, AICPA, and other organizations have provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the resulting accounting and auditing issues. The resources can be found at **https://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174469582**, **https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center**, **https://www.gfoa.org/coronavirus**, and **https://checkpoint.riag.com/.**

Audit Objectives and Requirements. The auditor's objectives under AU-C 570B 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.

The concept of going concern applies to governmental units as well as to business enterprises. AU-C 570B 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. However, GASBS No. 56 does specify the time period.

Risk Assessment Procedures and Related Activities. AU-C 570B 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 570B includes procedures for auditors to perform in the planning and risk assessment phases of the audit. AU-C 570B.12 requires that the auditor consider, when performing risk assessment procedures as discussed in AU-C 315B, 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 570B 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 the governing body 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 programs, or loss of a major taxpayer or grant.

h. Reviewing correspondence with lenders and rating agencies concerning debt arrangements and credit ratings.

AU-C 570B.A7 notes 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 570B.A7, AU-C 570B.A9, and SLG, Paragraph 15.23, include the following examples of such conditions or events:

a. Negative trends.

   (1) Declining tax or other revenue base such as declining population, school enrollment, per capita personal income, appraised value of real estate per capita, number and value of building permits or business licenses, or retail sales; major taxpayers in declining industries; adverse changes in tax rates or structure; reassessments; recessionary economy; etc.

   (2) Potential for large tax refunds, such as refunds resulting from taxpayers' challenges.

   (3) Continuing significant deficits in fund balance or net position, or a pattern of annual deficits in operating results.

   (4) Loss of significant grant revenues or other major funding sources.

   (5) Recurring periods of expenditures significantly exceeding revenues in governmental funds or recurring unsubsidized operating losses, negative cash flows, or adverse key financial ratios in enterprise funds.

b. Other indications of possible financial difficulties.

   (1) Default on bonds, loans, or similar agreements, including debt covenants.

   (2) Lowering bond ratings below investment grade.

   (3) Disallowance of grant expenditures or noncompliance with grant restrictions.

   (4) Noncompliance with required capital or reserve requirements (e.g., minimum fund balances).

   (5) Large investment losses (realized or unrealized).

   (6) Burdensome pension or other postemployment benefit plan obligations combined with declining revenues.

   (7) Approaching debt and tax limitations.

   (8) Unwillingness of government officials to pay legally incurred liabilities.

   (9) Unfavorable commitments for pensions or under split-interest agreements, automatic renewal grants, or other long-term programs.

   (10) Mushrooming costs on construction and similar long-term projects.

   (11) Need to seek new sources or methods of financing or dispose of substantial assets.

   (12) Restructuring of debt.

   (13) Excessive use of short-term borrowing, including tax and revenue anticipation notes, to reduce cash shortages.

(14) Long-term borrowing to eliminate deficits or to meet current operating needs.

(15) Increased borrowings from component units that are not expected to be repaid within a reasonable period.

(16) Extremely high estimated liability for actual or incurred but not reported (IBNR) claims in areas not insured, including large adverse legal decisions or settlements.

c. Policy decisions that affect the government's provision of services.

d. Internal matters.

(1) Severe discord among members of management and governing board, or loss of important board members.

(2) Substantial dependence on the success of a particular project or program.

(3) Uneconomic long-term commitments.

(4) Need to significantly revise operations, cut personnel, or curtail programs.

e. External matters that have occurred.

(1) Unwillingness of other governments to continue funding programs at current levels.

(2) Legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate.

(3) Unfavorable litigation outcome.

(4) Unfavorable reductions or changes in government cost reimbursement rates or structure.

(5) Losing a principal taxpayer or supplier.

(6) 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 570B requires the auditor's evaluation to address management's evaluation of the governmental unit'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 570B.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. AU-C 570B.A26 indicates that the financial reporting framework may provide additional guidance on this matter. GASBS No. 56 requires that if there is information currently known to the governmental unit that may raise substantial doubt shortly after one year beyond the financial statement date (for example, within three months), it should be considered. Besides that inquiry, no additional procedures are required for the identification of additional conditions or events that may raise substantial doubt about the governmental unit's ability to continue as a going concern beyond the period evaluated by management.

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 570B.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 budget or 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 budget that are inconsistent with evidence obtained while testing other audit areas (such as property or sales tax).

- Consider any facts or information that have become available since the date of management's evaluation.

AU-C 570B.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 positive 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 GASBS No. 56, the lack of a detailed analysis by management might be considered as an indicator of an internal control deficiency, as discussed in AU-C 265B.

Other Relevant Procedures. AU-C 570B.A28 and SLG, Paragraph 15.28, provide 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, budgets, or others.

- Analyze and discuss the most recently available interim financial statements.

- Review debt, loan, and grant agreements and determine whether any terms have been breached.

- Read minutes of meetings of the governing board 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.

- Confirm with related parties and third parties (e.g., lenders, other governments, component units) the existence and terms of arrangements to provide or maintain financial support and evaluate their adequacy.

- Obtain and review reports of regulatory actions.

- Obtain support for any planned asset disposals and determine its adequacy.

- Review correspondence from rating agencies for any downgrade of the governmental unit's credit rating (overall or specific issues).

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 570B.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 of the financial statement date (or shortly thereafter). These and other governmental examples include:

a. Plans to dispose of assets.

   (1) Restrictions on disposal of assets, such as debt or grant agreements that limit asset dispositions or other encumbrances.

   (2) Marketability of assets that management plans to sell.

   (3) Possible direct or indirect effects of disposal of the asset or activity.

b. Plans to issue or restructure debt.

   (1) Availability and terms given the governmental unit's credit rating.

   (2) Debt capacity and limits.

c. Plans to reduce or delay expenditures.

   (1) Feasibility of plans to reduce administrative expenditures, to postpone maintenance or construction projects, or to terminate programs.

   (2) Possible direct or indirect effects of reduced or delayed expenditures.

d. Plans to increase taxes.

   (1) Legal limits.

   (2) Ability to obtain required approvals or votes.

The auditor should consider the need to obtain additional evidential matter about management plans (including budgets or cash flow forecasts) and exercise an appropriate level of professional skepticism.

When a budget or cash flow forecast is a significant factor in the evaluation of management's plans, in addition to the matters discussed above regarding the reliability of underlying data and adequate support for assumptions, AU-C 570B.A30 notes that the auditor might compare prior budgets to historical actual results, as well as compare current budget information with actual results to date.

Management's plans may include financial support by third parties or related parties (such as component units), referred to as *supporting parties* in AU-C 570B. If funding from supporting parties provides a basis for management's assertion that the governmental unit has the ability to continue as a going concern, AU-C 570B 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. 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 570B.A32.) Any written support letter or confirmation ought to define a specific date through which the supporting party intends to provide support; for example, beyond a year and three months from the financial statement date. AU-C 570B.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.

Other management plans may include obtaining additional sources of revenues. For example, the government may increase tax levies or rates or obtain additional grants. The auditor ought to consider whether an increase in taxes is feasible (e.g., tax limitations, voter approval) or the grant has or will be approved and whether the governmental unit is capable of maintaining compliance with the terms of the grant (e.g., matching funds).

Auditor's Conclusions. AU-C 570B 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 governmental unit'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 GASBS No. 56.

Reporting Considerations. Guidance for reporting under AU-C 570B is outside the scope of this course, but more information is provided in *PPC's Guide to Auditor's Reports*.

Management's Representations. AU-C 570B.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 570B.28 requires certain communications with those charged with governance.

Significant Delays in Issuing the Financial Statements. AU-C 570B 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. 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 governmental unit's ability to continue as a going concern for a reasonable period of time before the consideration of management plans, AU-C 570B.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 auditor's conclusion concerning the effects on the auditor's report.

The authors recommend that, at a minimum, 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. A checklist can help summarize the consideration of management's plans and other procedures necessary when conditions or events are identified and may enable auditors to meet the documentation requirements of AU-C 570B.

THE USE OF ACCOUNTING ESTIMATES AND FAIR VALUE

Accounting Estimates

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, most investments, the allowance for doubtful accounts, or an impairment adjustment) or only disclosed in the notes (for example, synthetic guaranteed investment contracts that are fully benefit-responsive). AU-C 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides the authoritative guidance for auditing accounting estimates, including fair values. 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. The requirements that should be followed to achieve those objectives are set forth in AU-C 540B.

Preparation of financial statements normally requires making accounting estimates. AU-C 540B.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 540B 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.

Governmental unit financial statements include both fair value estimates and accounting estimates not based on fair value. SLG, Chapter 4 at Appendix A-14, indicates key estimates in governmental units include:

a. Allowance for uncollectible taxes receivable.

b. Investments measured at fair value not based on market prices or with permanent impairments, such as derivative instruments.

c. Useful lives of capital assets.

d. Compensated absence obligations.

e. Claims and judgments.

f. Termination benefits.

g. Municipal landfill closures and post-closure care costs.

h. Pension and OPEB benefits.

i. Pollution remediation obligations.

The exhibit to AU-C 540B provides additional examples of accounting estimates.

COVID-19 Estimates Considerations. COVID-19 has disrupted most aspects of life around the world, and has many implications for auditing, including significant considerations for the auditing of accounting estimates. The authors recommend auditors review a checklist of relevant COVID-19-related factors during the planning, risk assessment, and concluding phases of the audit and utilize it as a reference tool throughout the engagement.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to cover COVID-19-related audit issues in a general way. However, the GASB, AICPA, and other organizations, have provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the resulting accounting and auditing issues. The resources can be found at **https://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174469582**, **https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center**, **https://www.gfoa.org/coronavirus**, and **https://checkpoint.riag.com/.**

Auditing Accounting Estimates. When auditing accounting estimates, AU-C 540B 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 540B.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, including internal control. 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:

- 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 reestimation 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 240B, *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 organization's controls, including control activities. Accounting estimates with a higher degree of estimation uncertainty might also 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 540B.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.

The practice aids in *PPC's Guide to Audits of Local Governments* can assist the auditor in meeting the requirements associated with risk assessment procedures and related activities for auditing accounting estimates.

Responding to the Assessed Risks of Material Misstatement. The auditor's further audit procedures for identified accounting estimates should be responsive to the assessed 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 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 540B.13 requires the auditor to do one or more 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 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 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. Auditing fair value estimates is further discussed later in this section.

AU-C 540B.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 540B.04 requires certain procedures 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 concludes 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 540B 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. In fulfilling this requirement, the auditor should determine whether disclosures relating to accounting estimates are complete and appropriately presented and 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 540B.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 540B.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.

AU-C 240B.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 540B, AU-C 240B 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 the change in net position. 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 financial results. If the auditor believes that is the case, he or she should consider communicating the matter to those charged with governance, as discussed in Lesson 3.

AU-C 240B.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 540B.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 540B, 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 and Disclosures for Fair Value Measurements. GASBS No. 72, *Fair Value Measurement and Application*, defines fair value, outlines appropriate measurement approaches and inputs to determine fair value, and establishes measurement principles. In addition, the statement outlines disclosures that are intended to help users understand how the governmental unit has applied the principles of fair value measurement.

Auditing Fair Value Measurements and Disclosures. The requirements of AU-C 540B 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 general guidance of AU-C 540B relating to risk assessment procedures, identifying and assessing risks, and responding to assessed risks including significant risks, as well as other required matters, govern the auditor's procedures.

As previously noted, 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, include evaluating the appropriateness of the method, reasonableness of the assumptions, and reliability of the underlying data. This approach is frequently used when the accounting estimate involves fair value determined using a valuation method.

OBTAINING WRITTEN REPRESENTATIONS

Introduction and Authoritative Literature

AU-C 580B.09, *Written Representations*, requires the auditor to request written representations from management with appropriate responsibilities for the financial statements. Among other things, AU-C 580B.10–.11 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.

SLG, Paragraphs 15.11–.12, supplements the requirement by specifying certain representations that should be obtained in audits of governmental units.

AU-C 580B.25 indicates that, with respect to the representations required by AU-C 580B.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 705B, *Modification to the Opinion in the Independent Auditor's Report*, or withdraw from the engagement.

AU-C 580B 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 580B.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 580B.26 indicates that when management does not provide one or more of the 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 impact to the auditor's report pursuant to the guidance provided by AU-C 705B.

With respect to these other specific representations required by AU-C 580B.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 580B.12–.18, management's refusal may cause the auditor to withdraw or disclaim an opinion. AU-C 580B.A34, however, explains that, depending on the nature of 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 580B.10–.11, as explained above, a disclaimer or withdrawal is always required.

For the Single Audit, the GAS/SA Audit Guide, Paragraph 10.82, states that management's refusal to furnish written representations may constitute a scope limitation sufficient to preclude an unmodified opinion on compliance with major program requirements. In addition, the auditor should consider his or her ability to rely on other management representations because of management's refusal to furnish a written representation.

Written Representations as Audit Evidence

Written representations provide audit evidence but, according to AU-C 580B.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 580B.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 580B.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 580B.21 specifically requires that written representations be obtained in the form of a representation letter addressed to the auditor. Exhibit A to AU-C 580B provides an illustrative example of a representation letter.

SLG, Paragraphs 15.11–.12, lists representations that the auditor should request from management on an audit of governmental financial statements. In addition, the GAS/SA Audit Guide, Paragraphs 3.61 and 10.81, lists other representations that ordinarily should be obtained in Yellow Book and Single Audits, respectively. In addition, the Yellow Book requires auditors to obtain specific representations when the auditor prepares draft financial statements and related notes.

Materiality Threshold

AU-C 580B permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. AU-C 580B.A22 explains that 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 580B.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 authors discourage using a purely quantitative discussion of materiality because it is inappropriate to rely solely on quantitative considerations when determining materiality.

Materiality considerations would not apply to representations that have no direct relationship to financial statement (including notes thereto) amounts or to representations regarding information concerning fraud. Examples of representations that have no direct relationship to financial statement amounts include management's acknowledgment of its responsibility:

- For the fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America.
- To make available all financial records and related data and communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
- For the completeness and availability of all minutes of meetings of governing bodies.
- Related to information on fraud involving (a) management, (b) employees who have significant roles in internal control, or (c) others where the fraud could have a material effect on the financial statements.

Federal Award Programs. The authors do not believe the quantitative approach is practical with respect to federal award programs for a Single Audit. In those instances, the discussion should be tailored to reflect the requirements of the Uniform Guidance.

Uncorrected Misstatements

AU-C 580B.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. A summary of the uncorrected misstatements should be included in or attached to the representation letter. AU-C 580B 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), the authors believe 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). 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.

There should be a summary for each opinion unit. If the auditor aggregates the misstatements, they normally would be aggregated by financial statement caption. Amounts need to be presented in sufficient detail to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements.

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 450B, *Evaluation of Misstatements Identified During the Audit*, discussed in Lesson 2. Nevertheless, compliance with AU-C 580B, certainly is simplified if management records all audit adjustments. In many cases, especially smaller governmental entities that rely on the auditor for accounting knowledge, management will agree to record all 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 240B, *Consideration of Fraud in a Financial Statement Audit*, or AU-C 250B, *Consideration of Laws and Regulations in an Audit of Financial Statements*. That guidance addresses different communication responsibilities. The auditor considers the client's decision to not record the audit adjustments when identifying and assessing fraud risk, but the decision to not record all proposed adjustments does not necessarily mean the client is intentionally misstating the financial statements.

Those Charged with Governance

AU-C 260B, *The Auditor's Communication With Those Charged With Governance*, requires the auditor to provide those individuals with written representations requested from management. AU-C 580B.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 580B.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 lawsuit may depend on whether those charged with governance intend to settle or contest the matter.

Those with Specialized Knowledge

AU-C 580B.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 580B.A4 provides the following examples of such individuals:

- Actuaries who are responsible for actuarially determined accounting measurements (e.g., pension liabilities, OPEB liabilities).
- 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 580B.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.

Periods Covered by the Letter

AU-C 580B.20 requires written representations from management who have 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 580B.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 current year's auditor's report covers the current and prior periods, the representation letter should cover both periods. This can present practical problems in a governmental unit audit. Administrative officials may be elected for a term that differs from the governmental unit's financial reporting year. A newly elected individual may be reluctant to sign representations relating to the period prior to the beginning of his or her term of office. The auditor still has to insist on written representations from current management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

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 (a) the prior period financial statements were audited by a predecessor auditor, (b) the predecessor auditor's report on the prior period's financial statements is not reissued, and (c) 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 700B.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 related to opening balances, such as prior period internal control deficiencies, consistency in accounting policies, and matters related to report modifications.

Signatures on the Representation Letter

The letter generally should be signed by the chief executive officer and the chief financial officer; e.g., the mayor, city manager, school superintendent and the finance officer, school district business manager. However, according to AU-C 580B.09, the auditor should request management with appropriate responsibilities for the financial statements and knowledge of the matters concerned to provide written representations. The auditor should inform those individuals well ahead of time (possibly in the engagement letter) of the need to sign the management representation letter.

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 580B.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.

Dating, Receipt, and Updating of the Letter

Dating of the Letter. The auditor is concerned with matters occurring through the date of his or her report, not merely through the financial position statements date. As a result, the management representation letter should be dated as of the date of the auditor's report.

Receipt of the Letter. AU-C 580B.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 reviewed 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 management representation letter prior to releasing the auditor's 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 the auditor to disclaim an opinion or withdraw from the engagement.

Updating Letters. Certain circumstances require auditors to obtain updating representation letters from management. AU-C 560B 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 statement of net position date of the financial statements reported on by the predecessor require disclosure in or adjustment to such financial statements.

Alternative Wording for a Small Governmental Unit

In a small governmental engagement, it may be advisable to modify some of the standard wording of the representation letter to define technical terms that may not be understandable to the administrator of a small governmental unit and, in general, to make the administrator more comfortable with the reasonableness of the representations being requested. For example, technical terms that are discussed in authoritative literature, but that are generally unfamiliar to an administrator of a small governmental unit, include *fraud* and *accounting estimates*. Also, in a small governmental engagement, certain additional representations may be desirable.

Exhibit 1-2 presents suggestions for alternative wording of a management representation letter for a small governmental engagement. The suggested wording defines terms with a specific technical meaning and, in general, modifies the wording to make it more suitable for the circumstances of a small governmental engagement. For example, an administrator who has relied on an auditor to prepare financial statements is likely to be uneasy about the standard acknowledgment of responsibility for the financial statements.

Exhibit 1-2

Examples of Alternative Wording of Representations for Small Governmental Units

Standard Letter	Alternative Wording[a]
The financial statements referred to above are fairly presented in conformity with U.S. generally accepted accounting principles and include all properly classified funds and other financial information of the primary government and all component units required by generally accepted accounting principles to be included in the financial reporting entity.	The financial statements referred to above are fairly presented in conformity with U.S. generally accepted accounting principles and include all properly classified funds and other financial information of the primary government and all component units required by generally accepted accounting principles to be included in the financial reporting entity. *Component units are separate organizations, functions, and activities of government. The primary government is the unit of government directly responsible to the [name of chief executive and the elected legislative body such as the mayor and city council] that has oversight responsibility over those other organizations, functions, and activities*.
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 [Describe governmental unit; e.g., city, county, school district, etc.] 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 [Describe governmental unit; e.g., city, county, school district, etc.] *(intentional misstatements or omissions of amounts or disclosures in financial statements or misstatements arising from misappropriations of assets)* and involves *administrative officials*, employees who have significant roles in *processing transactions or safeguarding assets*, or others where the fraud could have a material affect on the financial statements.
All material transactions have been recorded in the accounting records and are reflected in the underlying financial statements.	All material transactions have been recorded in the accounting records and are reflected in the underlying financial statements *and there are no undisclosed assets, liabilities, deferred outflows of resources, or deferred inflows of resources*.

Note:

[a] Modifications are italicized for emphasis.

Scope Limitations

It is clear that management's refusal to furnish written representations is a limitation on the scope of the engagement sufficient to preclude an unmodified opinion. AU-C 580B.A34 clarifies that while management's refusal to furnish requested written representations constitutes a limitation on the scope of the audit, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion (rather than a disclaimer or withdrawal) is appropriate. The authors believe that situations resulting in a qualified opinion will be limited to those where only one or perhaps a few representations are refused. For the Single Audit, the GAS/SA Audit Guide, Paragraph 10.82, states that management's refusal to furnish all written representations that the auditor considers necessary constitutes a scope limitation sufficient to require a qualified opinion or a disclaimer of opinion on compliance with major program requirements. In addition, the auditor should consider his or her ability to rely on other management representations because of management's refusal to furnish a written representation.

Even if a written representation is obtained regarding a matter, there is a limitation on the scope of the audit if the auditor is prevented from performing other procedures he or she considers necessary relating to the same matter. In those instances, the auditor should issue a qualified opinion or disclaimer of opinion.

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 events generally should **not** result in adjustments to the financial statements?
   a. Nonrecognized events.
   b. Recognized events.
   c. Subsequent events.
5. Which of the following statements is correct regarding an auditor's review of subsequent events?
   a. Whether or not a subsequent event is reported should be decided at the opinion unit level, not for the governmental entity as a whole.
   b. The auditor should perform subsequent events review procedures intermittently from the date of the auditor's report until the next audit begins.
   c. Reissued financial statements should remain static as of their issuance date, even if subsequent events occurred that influence the statements.
   d. Subsequent events should specifically be excluded from the Management's Discussion and Analysis (MD&A) section.
6. Sun Island National Seashore, a government agency, should include which of the following when disclosing a related-party transaction in the notes to the financial statements?
   a. A statement that the transaction is equivalent to arm's length.
   b. A statement that related-party transactions occurred.
   c. Dollar amounts involved in the transaction.
   d. The form of the transaction if different from its substance.
7. Which of the following statements is correct regarding accounting estimates in a governmental audit?
   a. Both an understanding of GAAP requirements and a risk-based approach are needed when auditing accounting estimates.
   b. Accounting estimates are more dependent upon judgment when they have a lower estimation uncertainty.
   c. The only appropriate auditing procedure needed for accounting estimates is making inquiries of management.
   d. The nature and reliability of information used in accounting estimates is the same for all estimates in an audit engagement.
8. Nina, a CPA, is engaged to audit a local government. She requests written representations from the administrative officials who have appropriate responsibilities for the financial statements. However, the officials refuse to provide all the representations required by AU-C 580B.10–.11 even after Nina discusses the issue with them. How will this affect Nina's audit engagement?
   a. She can still express an unmodified opinion on her client's financial statements.
   b. She must disclaim an opinion or withdraw from the engagement.
   c. She must mention the issue in an emphasis-of-matter paragraph in the auditor's report.

SELF-STUDY ANSWERS

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

4. Which of the following events generally should **not** result in adjustments to the financial statements? **(Page 344)**

   a. **Nonrecognized events. [This answer is correct. These events provide evidence with respect to conditions that did not exist at the date of the statement of net position but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that their disclosure is essential to a user's understanding of the financial statements.]**

   b. Recognized events. [This answer is incorrect. These events provide additional evidence with respect to conditions that existed at the date of the statement of net position and affect estimates inherent in the process of preparing the financial statements. All information that becomes available prior to the issuance of the financial statements should be used in evaluating the conditions on which estimates are based, and the financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.]

   c. Subsequent events. [This answer is incorrect. These are events or transactions that affect the financial statements and occur subsequent to the statement of net position date, but before the financial statements are issued. However, subsequent events are broken down into two types of events, so there is a better answer to this question.]

5. Which of the following statements is correct regarding an auditor's review of subsequent events? **(Page 344)**

   a. **Whether or not a subsequent event is reported should be decided at the opinion unit level, not for the governmental entity as a whole. [This answer is correct. According to SLG, paragraph 15.38, the reporting of subsequent events should be evaluated in relation to the individual opinion unit affected by the event.]**

   b. The auditor should perform subsequent events review procedures intermittently from the date of the auditor's report until the next audit begins. [This answer is incorrect. According to AU-C 560B.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; therefore, subsequent events review procedures need to be performed up through the date when the auditor has obtained sufficient evidence to support the opinion on the financial statements. In addition, it is ordinarily expected that the date of the auditor's report will be close to the report release date.]

   c. Reissued financial statements should remain static as of their issuance date, even if subsequent events occurred that influence the statements. [This answer is incorrect. In cases where financial statements have been reissued, or are reissued in comparative form with financial statements of subsequent periods, events that have occurred since the original date of issue may require disclosure if they are considered essential to the user's understanding of the financial statements. These events will result in an adjustment of the financial statements only if the adjustment meets the criteria for the correction of an error or a prior period adjustment.]

   d. Subsequent events should specifically be excluded from the Management's Discussion and Analysis (MD&A) section. [This answer is incorrect. Paragraph 11(h) of GASBS No. 34 requires that currently known facts, decisions, or conditions that are expected to have a significant effect on the government's financial position or results of operations be discussed as part of MD&A. Further, GASBS No. 56 states that, depending on the facts and circumstances, a discussion of subsequent events in MD&A may be necessary.]

6. Sun Island National Seashore, a government agency, should include which of the following when disclosing a related-party transaction in the notes to the financial statements? **(Page 347)**

   a. A statement that the transaction is equivalent to arm's length. [This answer is incorrect. Related-party disclosures generally should not imply that transactions were equivalent to arm's length because such representations usually cannot be substantiated. GASBS No. 56 observes that governments frequently enter into transactions and engage in activities that are driven by societal needs and concern for the "public good." As a result, comparison of governmental programs and arrangements to what might have occurred in an arm's-length transaction in the private sector may not be appropriate.]

   b. A statement that related-party transactions occurred. [This answer is incorrect. To meet the requirement at GASB Cod. Sec. 2250.102, it would be a best practice for the government to disclose more information than just a statement, including a description of the transaction for each of the periods for which financial statements are presented, and other information deemed necessary to an understanding of the effects of the transactions on the financial statements (including transactions to which no amounts or nominal items were ascribed).]

   c. **Dollar amounts involved in the transaction. [This answer is correct. GASB Cod. Sec. 2250.102 requires that the financial statements disclose related-party transactions. GASB Cod. Sec. 2250.107 provides that disclosures should include, among other things, the dollar amounts of transactions for each of the periods for which financial statements are presented, and the effects of any change in the method of establishing the terms from that used in the preceding period.]**

   d. The form of the transaction if different from its substance. [This answer is incorrect. GASBS No. 56 provides guidance for accounting for related-party transactions that emphasizes the critical importance of *substance over form*. When the involvement of related parties causes the substance of a particular transaction to be significantly different from its form, the financial statements should recognize the substance of the transaction rather than merely its legal form.]

7. Which of the following statements is correct regarding accounting estimates in a governmental audit? **(Page 359)**

   a. **Both an understanding of GAAP requirements and a risk-based approach are needed when auditing accounting estimates. [This answer is correct. When auditing accounting estimates, AU-C 540B emphasizes that the auditor should follow a risk-based approach. Also, the auditor should understand the requirements of GAAP related to relevant estimates, including the pertinent disclosure requirements.]**

   b. Accounting estimates are more dependent upon judgment when they have a lower estimation uncertainty. [This answer is incorrect. According to AU-C 540B.A47, estimates with a high estimation uncertainty are highly dependent on judgment. Therefore, one with lower uncertainty would not be as dependent on judgment.]

   c. The only appropriate auditing procedure needed for accounting estimates is making inquiries of management. [This answer is incorrect. In responding to assessed risks for accounting estimates, AU-C 540B.13 requires the auditor to do one or more of the following: (1) test the operating effectiveness of the controls over how management made the estimate, along with appropriate substantive procedures; (2) determine if subsequent events up to the date of the auditor's report provide audit evidence about the estimate; (3) test how management made the estimate and the underlying data, including the evaluation of the appropriateness of the method, reasonableness of the assumptions, and reliability of the underlying data; and (4) develop a point estimate or range to evaluate management's point estimate.]

   d. The nature and reliability of information used in accounting estimates is the same for all estimates in an audit engagement. [This answer is incorrect. 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.]

8. Nina, a CPA, is engaged to audit a local government. She requests written representations from the administrative officials who have appropriate responsibilities for the financial statements. However, the officials refuse to provide all the representations required by AU-C 580B.10–.11 even after Nina discusses the issue with them. How will this affect Nina's audit engagement? **(Page 363)**

   a. She can still express an unmodified opinion on her client's financial statements. [This answer is incorrect. The importance of AU-C 580B's requirement for representations is emphasized by the fact that an inability to obtain appropriate representations prevents an auditor from expressing an unmodified opinion.]

   b. **She must disclaim an opinion or withdraw from the engagement. [This answer is correct. Disclaiming an opinion or withdrawing is required by AU-C 580B.25 when the written representations required by AU-C 580B.10–.11 are either (1) not provided by management or (2) the auditor cannot rely on the representations due to the auditor concluding that sufficient doubt exists about management's integrity.]**

   c. She must mention the issue in an emphasis-of-matter paragraph in the auditor's report. [This answer is incorrect. The lack of representations is a serious issue in an audit engagement. Merely mentioning the lack of representations in an emphasis-of-matter paragraph would not meet the requirements listed in the clarified auditing standards.]

Lesson 2: Additional Steps for Completing the Audit

INTRODUCTION

This lesson takes a look at other steps that must be performed at the conclusion of an audit engagement. It begins with a discussion of the consideration of the accumulated results of the audit procedures that were performed. Next, Lesson 2 takes a look at analytical procedures and the different reviews that must be performed on the workpapers. Finally, this lesson ends with a discussion of summarizing uncorrected misstatements and evaluating the accumulated results of auditing procedures. Guidance related specifically to governmental audits, such as information provided in *Government Auditing Standards*, is included where applicable.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify steps for considering accumulated results of audit procedures, analytical procedures in concluding the audit, and reviewing workpapers.
- Recognize issues on uncorrected misstatements and evaluating accumulated results of audit procedures.

THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, as amended by SAS No. 134, at AU-C 315B.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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, at AU-C 330B.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 2-1 (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 2-1

Reevaluating the Initial Assessment of the Risk of Material Misstatement at the Relevant Assertion Level

When planning the audit of the City of Briny Beach, the auditor initially assessed a low level of risk that the City would not record revenue from state grants in the proper period. The auditor then determined the nature, timing, and extent of substantive procedures related to the cut-off assertion based on the auditor's assessment of a relatively low risk of material misstatement. However, the City's accountant was confused about how to record revenues for cost reimbursement grants whose expenditures were incurred before year end but reimbursement requests not submitted until after fiscal year end.

In her examination of grants receivable, the auditor sent confirmations to a sample of grantors. Confirmation results indicated a likely misstatement. The auditor informed management and the investigation led to identifying cut-off issues as the cause of the misstatement. As a result, the auditor (1) asked management to examine the grants receivable and revenue account balances to identify and correct any other misstatements, and (2) reevaluated the initial risk assessment relating to cut-off and increased the extent of tests of details 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 2-1, 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.

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 opinions 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 of each opinion unit, 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 330B.A76 indicates 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 330B.29 states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a relevant 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 2-2.

Exhibit 2-2

Conditions That May Change or Support the Auditor's Assessment of Fraud Risks

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, fund, or government 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 copies 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 government'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 specialist 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.

COVID-19 Fraud Risk Assessment Considerations. COVID-19 has disrupted most aspects of life around the world, and has many implications for auditing, including increasing the focus to assess the risk of fraud due to material misstatement throughout the audit. The authors recommend auditors review a checklist or other practice aid related to COVID-19 factors during the planning, risk assessment, and concluding phases of the audit and utilize it as a reference tool throughout the engagement.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to cover COVID-19-related audit issues in a general way. However, the GASB, AICPA, and other organizations have provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the resulting accounting and auditing issues. The resources can be found at **https://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174469582**, **https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center**, **https://www.gfoa.org/coronavirus**, and **https://checkpoint.riag.com/.**

Required Procedures. AU-C 240B.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, performance of analytical procedures relating to revenue is required 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. In addition, 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 240B.32 requires the auditor to evaluate the business purpose for significant unusual transactions to address the risk of management override of controls by considering whether the business purpose (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 purpose for significant unusual transactions, AU-C 240.32c, as amended by SAS No. 135, requires that the auditor's procedures include the following—

- Read underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations the auditor has obtained through inquiries or other audit evidence about the business purpose of the transaction.
- Determine whether the transaction has been authorized and approved in accordance with the policies and procedures established by the entity.
- Evaluate whether identified significant unusual transactions have been properly accounted for and disclosed.

AU-C 240.A54, as amended by SAS No. 135, describes the following indicators that may suggest a significant unusual transaction has been entered to engage in fraudulent financial reporting or to conceal misappropriation of assets:

- Transaction form appears overly complex.
- Management failed to discuss the nature of and accounting for the transaction.
- Inadequate transaction documentation.
- Management placed more emphasis on the particular accounting treatment of the transaction than on its economic substance.

- The transaction involved nonconsolidated related parties, including special purpose entities.
- The transaction was not properly reviewed or approved by those charged with governance.
- The transaction involved related parties or relationships or transactions with them that were previously not disclosed to the auditor.
- The transaction involved other parties lacking substance or the financial ability to support the transaction without the entity's, or a related party of the entity's, assistance.
- The transaction lacked commercial or economic substance or was part of a larger series of connected, linked, or otherwise interdependent arrangements lacking commercial substance individually or in the aggregate.
- The transaction falls outside the GAAP definition of a related party, but either party is able to negotiate terms that may not be available to other, more clearly independent parties on an arm's-length basis.
- The transaction enables the entity to achieve certain financial targets.

AU-C 240.A55, as amended by SAS No. 135, suggests the following additional procedures for evaluating significant unusual transactions:

- Evaluate the financial capability of the other parties to the transaction in relation to uncollected balances, loan commitments, supply arrangements, guarantees, or other similar arrangements.
- Evaluate the financial capability of a related party by considering information such as the related party's audited financial statements, regulatory agency reports, tax returns, if applicable, or coverage in financial publications.

Considering the Application of Significant Accounting Principles for Bias

According to AU-C 240B.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 230B.08 requires auditors to document, in addition to significant audit findings, 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, as clarified by SAS No. 134, requires the auditor to perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with GAAP, including consideration of whether the financial statements are presented in a manner that reflects the following:

- Appropriate classification and description of financial information and the underlying transactions, events, and conditions.
- Appropriate presentation, structure, and content.

AU-C 330.A72, as clarified by SAS No. 135, explains that evaluating appropriate presentation, structure, and content includes consideration of terminology required by GAAP, level of detail provided, aggregation and disaggregation of amounts, and the bases of amounts set forth.

In forming an opinion on financial statements, according to AU-C 700.15, as clarified by SAS No. 134, 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. (SAS No. 134 clarifies that to make this evaluation, the auditor evaluates whether all required information is included and whether the information presented is appropriately classified, aggregated or disaggregated, and presented.)
- Disclosures enable intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
- 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 (e.g., statement of net position, balance sheet, 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, the auditor needs to consider the potential for error or fraud in disclosures at the assertion level. Sufficient attention to disclosures is an essential and integral part of an effective audit. AU-C 450B.04 defines a misstatement as a difference between the reported amount; classification, presentation, or disclosure; and the amount 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 450B.A1 include the following:

- An omission of an amount or disclosure, including inadequate or incomplete disclosures and omission of disclosures required to meet disclosure objectives of GAAP.
- A financial statement disclosure that is not presented in accordance with GAAP.

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. The authors believe 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 governmental unit in order to identify early in the audit the areas in which there may be risks of material misstatements 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 (e.g., other post retirement benefits, tax abatements, or asset retirement obligations).
- Changes in the governmental unit's activities, environment, or financial condition that might result in significant new or revised disclosures.
- Particular transactions, such as a service concession arrangement, 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, SAS No. 134 adds to AU-C 240.A6 the point that management may intentionally override controls to omit, obscure, or misstate disclosures required by GAAP or that are necessary to achieve fair presentation. It also adds the suggestion to AU-C 240.A13 that the engagement team discussion include consideration of the risk management may attempt to present disclosures in a way that obscures a proper understanding of the matters disclosed, such as by the use of unclear or ambiguous language.

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 outside of the general and subsidiary ledgers, including qualitative disclosures. AU-C 315.19, as amended by SAS No. 134, expands upon the auditor's requirement to obtain an understanding of the information system to clarify that the understanding should include the aspects relevant to information disclosed that is obtained from within or outside of the general and subsidiary ledgers.

AU-C 315.A94, as added by SAS No. 134, provides the following examples of information that may be required for disclosures that would have to be obtained from outside of the general and subsidiary ledgers:

- Lease agreement information, such as renewal options or future payments.
- Information from the entity's risk management system.
- Information on fair value from an expert engaged by management.
- Information from models or other calculations used to develop estimates related to data and assumptions used.
- Sensitivity analyses from financial models.
- Analyses prepared to support management's evaluation of going-concern status.

Additional examples of disclosures that might include information from outside of the general and subsidiary ledgers include the following:

- The nature of related party relationships.
- How and why the governmental unit uses derivative instruments.
- The description of investment policies and strategies of a pension or other postretirement benefit plan.
- The description of accounting policies and the nature of changes in such policies.
- The description of retirement and OPEB benefit plans and related obligations, including significant assumptions and inputs in determining the net pension liability.
- The nature and amounts related to significant tax abatement agreements.

AU-C 315.A106, as clarified by SAS No. 134, indicates that control activities relevant to the audit that address risks of material misstatement of disclosure information may relate to information obtained from outside of the general and subsidiary ledgers. Information from outside of the general and subsidiary ledgers may 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. AU-C 330.26, as clarified by SAS No. 134, on the adequacy of presentation of the financial statements, requires the auditor to perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with GAAP, including (a) appropriate classification and description of the underlying transactions, events, and conditions and other financial information, and (b) appropriate financial statement presentation, structure, and content.

Materiality Considerations Related to Disclosure. Materiality is an important consideration in designing and performing further procedures pertinent disclosure. Potential misstatements of financial statements generally are considered material there is a substantial likelihood that those misstatements would influence a reasonable user's judgment based on those financial statements and, considering materiality involves both its quantitative and qualitative aspects. In audit planning, materiality is based primarily on quantitative considerations. Nevertheless, particularly for matters of disclosure, qualitative considerations may be important. AU-C 320.06, as clarified by SAS No. 134, observes that the nature (a qualitative aspect) of potential misstatements in disclosures is relevant in designing audit procedures to respond to risks of material misstatement.

AU-C 320.A1, as added by SAS No. 134, suggests that when considering whether misstatements in qualitative disclosures could be material, the auditor may focus on factors such as the following:

- Circumstances during the period of the financial statements, such as consummating a significant business combination.
- Changes in GAAP, such as a new accounting standard that requires new qualitative disclosures (for example, the most significant individual commitments made, other than the abated tax, related to tax abatements).
- Effect of the nature of the entity on qualitative disclosures important to users, such as investment policies of an external investment pool.

Also, AU-C 315.A147, as added by SAS No. 134, notes that potential misstatements in individual statements and disclosures may be determined to be material based on the consideration of size, nature, or circumstances.

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. 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 government's activities and operations, such as unassigned general fund balance as a percentage of general fund expenditures.

During the audit, as further procedures are performed, the auditor needs to accumulate and assess the disclosure misstatements 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?

<u>Use of an Auditor's Specialist for Disclosure Information.</u> 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 obtained from outside of the general and subsidiary ledgers, 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, intangible assets may be valued or asset impairments assessed 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.

<u>Disclosure Matters Related to the Financial Reporting Process.</u> AU-C 315B.19 requires the auditor to obtain an understanding of the information system, including the related processes relevant to financial reporting, and identifies the financial reporting process, including disclosures, as one of the areas of necessary understanding. AU-C 315.19 is clarified by SAS No. 134 to specifically require the auditor to obtain an understanding of aspects of the information system relevant to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers.

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 governmental units, 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 governmental unit may be sensitive about disclosure concerning related parties, but GASB Cod. Sec. 2250.107 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. The description of the transaction has to make the understanding of the effects on the financial statements clear and understandable. 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 relationships and 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. A review of a disclosure checklist may assist in identifying relevant disclosures.
- 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 outside the general and subsidiary ledgers.
  - Procedures to agree or reconcile disclosure information with the underlying accounting records and with sources outside of the general and subsidiary ledgers.

USING ANALYTICAL PROCEDURES AND REVIEWING WORKPAPERS

Analytical Procedures

Introduction and Authoritative Literature. AU-C 520B.06 requires the use of analytical procedures near the end 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 opinions on the financial statements. In other words, the auditor uses analytical procedures at this stage to assess whether the financial statements of each opinion unit 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 activities, and its operating characteristics?

Overall Review. AU-C 520B.A25 states that this overall review would ordinarily include consideration of—

- The adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit.
- Unusual or unexpected balances or relationships not previously identified.

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 matters identified during preliminary analytical procedures, as well as matters that become apparent for the first time during the final review. If the auditor does not have a sufficient understanding of the cause of unusual or unexpected relationships, the auditor may need to revise the assessment of risks 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 whether 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 objectives of applying the analytical procedures may differ, the procedures actually applied may be very similar. 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 comparison to prior period amounts at the financial statement level may be 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 often performed during the risk assessment process to develop the audit strategy and then repeated for the draft financial statements in the final review. The authors do not believe a flux analysis is required by AU-C 520B, 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 than reperformed in the final review.

AU-C 240B 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 may be updated during the final analytical review stage of the audit. In addition, AU-C 240B.22 states that the auditor should evaluate whether analytical procedures performed as part of the risk assessment process affect the assessment of the risk of material misstatement due to fraud.

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 governmental engagements, the audit senior may be the only staff performing the engagement.

Authoritative pronouncements establish only broad requirements for supervision and review. AU-C 220B.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.

Quality Control System. SQCS No. 8 (QC 10.35–.36) indicates 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 (QC 10.A35, AU-C 220B.A16):

- The work has been performed in accordance with professional standards and applicable regulatory and legal requirements.
- Significant findings and issues have been raised for further consideration.
- Appropriate consultations have taken place and the resulting conclusions have been 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 is appropriately documented.
- The evidence obtained is sufficient and appropriate to support the report.
- The objectives of the procedures performed have been achieved.

The standards provide the following guidance on supervision and review of the engagement:

- 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 and the assessed risks of material misstatement (AU-C 300B.A18).
- 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 (AU-C 220B.22).
- The work performed by each assistant should be supervised and a suitably experienced team member should review the work of other team members. The engagement partner may delegate parts of the review responsibility to other assistants, in accordance with firm quality control policies (AU-C 220B.A15).
- If differences of opinion concerning accounting or auditing issues exist among firm personnel, an assistant should be able to document disagreement with the resolution of a matter. The engagement partner and assistants should be aware of the procedures to be followed when there are differences of opinion among the auditors about accounting and auditing issues. Also, assistants have a professional responsibility to bring disagreements or concerns that they have with respect to accounting and auditing issues that they believe are significant to the financial statements or the auditor's report to the attention of appropriate individuals in the firm (AU-C 220B.23).

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 230B.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 states 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—

- adherence to professional standards and firm policies and practices;
- integration of results and conclusions from work on individual financial statement components; and
- proper summarization of the results of audit tests, including significant audit findings or issues, for the attention of the supervisory reviewer and 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 within each opinion unit, 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 and dates; indexed; the conclusion signed; 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 element that is relevant to another element 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 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 reports. (These matters are discussed in more detail later in this lesson and in Lesson 3.)

AU-C 230B.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. Both AU-C 230B.09 and *Government Auditing Standards* require the workpapers to include evidence of the supervisory review. Supervisory reviewers should document their review of specific audit documentation and when it occurred. Some reviewers may prefer to document their review in a memo format that indicates the specific workpaper sections reviewed and associated dates.

Generally, the supervisory review focuses more on the summary and evaluation schedules, and documentation of significant 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 is the final check on whether the audit work supports the overall conclusions on the financial statements. The review of the workpapers should be performed before the date of the auditor's report.

Any review notes or comments from the earlier stages' 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.

Government Auditing Standards Requirement. *Government Auditing Standards* establish an additional requirement for supervisory review. Paragraph 6.31 of the Yellow Book indicates that auditors should document evidence of supervisory review of the work performed before the report release date. A GAO official indicated he would expect to see supervisory initials on "significant" workpapers, such as summary spreadsheets and other "important" workpapers," when performing a quality control review of a firm. The supervisory initials may be those of an owner or someone in a supervisory position.

Review Checklists. Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a 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 usually has to review his 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. This 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.

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 (EQCRs) 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 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 or to an oversight agency for grants.
- High profile clients, for example, well-known individuals or entities in the local community.
- Entities subject to governmental regulations.
- New types of services for the firm; for example, the firm begins to perform Single Audits.
- New or complex specialized industries.
- Clients without competent or experienced accounting personnel.

- Clients with substantial fraud risk factors.
- Clients with significant related-party transactions.
- Clients that have experienced material misstatements or noncompliance 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, that review should be completed before the audit report is released (QC 10.40). The authors recommend that an engagement quality control review be performed on each audit. The firm may wish to use a checklist based on specific firm policies.

<u>EQCR for Smaller Firms and Sole Practitioners.</u> 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.

When an individual external to the firm is engaged to perform an EQCR, the authors believe the firm needs to devote additional attention to obtaining information about that individual that is relevant to ensuring the individual's independence and compliance with other relevant ethical requirements. A firm is likely to have less information on the individual's financial, family, and other relevant relationships for an audit client than it does for staff members. AU-C 220B.09 indicates that the relevant ethical requirements to which the engagement quality control reviewer is subject include the AICPA *Code of Professional Conduct*, rules of applicable state boards of accountancy, and applicable regulatory agencies. This means that the external individual performing an EQCR is subject to the same independence and other ethical requirements as the engagement team. The EQCR should affirm that he or she is familiar with the applicable independence requirements and the firm needs to request any information that might be considered to have a bearing on independence of the reviewer. There also needs to be some investigation into and documentation of the ECQR's applicable qualifications, such as experience, education, and licensure.

Relationship of Workpaper Review to Dating of the Auditor's Report. AU-C 700B.41 (AU-C 700.42 after the adoption of SAS No. 134) 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 220B.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. The authors believe that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220B.A17 observes that the engagement partner may review all audit documentation, but need not do so. AU-C 230B.09c requires documentation of who reviewed the audit work and the review's date and extent.

AU-C 220B.21 notes specifically 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 230B.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 230B.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.

9. Which of the following auditors has correctly evaluated the existence of fraud in a governmental audit?

   a. Otis performs his assessment of the risks of material misstatement due to fraud at the conclusion of the audit.

   b. Dinah changes her assessment of fraud risks when she discovers unauthorized transactions have occurred.

   c. Solomon determines that it is not necessary for him to evaluate whether the accumulated results of audit procedures affect his original assessment about fraud risk.

   d. Tina determines that fraud risk is low enough on this audit that substantive procedures are not necessary.

10. According to AU-C 520B.A25, an overall review at the end of the audit should typically include which of the following?

    a. Performance of a flux analysis.

    b. Consideration of unusual or unexpected relationships or balances not identified previously.

    c. Consideration of the adequacy of evidence related to the financial statements as a whole.

    d. Performance of analytical procedures that differ significantly from those performed during audit planning.

11. Norah, an auditor, is in the final stage of her governmental audit. How should her workpapers be reviewed?

    a. There should be a two-stage review—detailed and higher level.

    b. The specific requirements laid out in AU-C 220B must be followed.

    c. The audit documentation will be judged sufficient if it just covers who performed the work and when.

12. Victoria, a CPA, is tasked by her firm to review the audited financial statements, auditor's report, and other communications and reports for the audit of a local government. Victoria was not part of the audit team. What type of review has she performed?

    a. A detailed review.

    b. A supervisory review.

    c. An engagement quality control review.

13. Percy & Sons CPA firm is engaged to audit a local government for the fiscal year ending December 31, 2020. They begin the audit on January 31, 2021. The engagement team has sufficient appropriate audit evidence as of March 15, 2021. The auditor's report is dated March 31, 2021. The report release date is April 15, 2021. On which of the following dates must the firm have detailed, supervisory, and engagement partner's reviews completed?

    a. January 31, 2021.

    b. March 31, 2021.

    c. April 15, 2021.

    d. June 14, 2021.

SELF-STUDY ANSWERS

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

9. Which of the following auditors has correctly evaluated the existence of fraud in a governmental audit? **(Page 376)**

   a. Otis performs his assessment of the risks of material misstatement due to fraud at the conclusion 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. Therefore, Otis should not limit his evaluation of the existence of fraud to the conclusion of the audit.]

   b. **Dinah changes her assessment of fraud risks when she discovers unauthorized transactions have occurred. [This answer is correct. An example of conditions that the auditor may note that may change or support the assessment of fraud risks made during planning is balances or transactions that are unsupported or unauthorized. Another example of such a condition is unrecorded transactions or transactions recorded improperly as to account, amount, period, fund, or government policy.]**

   c. Solomon determines that it is not necessary for him to evaluate whether the accumulated results of audit procedures affect his original assessment about fraud risk. [This answer is incorrect. AU-C 240B.34 require auditors to evaluate, at or near the completion of fieldwork, whether the accumulated results of auditing procedures 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.]

   d. Tina determines that fraud risk is low enough on this audit that substantive procedures are not necessary. [This answer is incorrect. 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.]

10. According to AU-C 520B.A25, an overall review at the end of the audit should typically include which of the following? **(Page 384)**

    a. Performance of a flux analysis. [This answer is incorrect. One common form of documentation of this overall review is referred to as a flux analysis. However, performance of a flux analysis is not required to be a part of the overall review by AU-C 520B.A25.]

    b. **Consideration of unusual or unexpected relationships or balances not identified previously. [This answer is correct. AU-C 520B.A25 states that this overall review would ordinarily include consideration of two things, one of them being unusual or unexpected balances or relationships not previously identified. This will help the auditor consider whether the information gathered during the audit provides a sufficient understanding of unusual or unexpected financial statement relationships.]**

    c. Consideration of the adequacy of evidence related to the financial statements as a whole. [This answer is incorrect. AU-C 520B.A25 states that this overall review would ordinarily include consideration of the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or during the audit.]

d. Performance of analytical procedures that differ significantly from those performed during audit planning. [This answer is incorrect. Although the objectives of applying preliminary and final review analytical procedures may differ, the procedures actually applied may be very similar. 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.]

11. Norah, an auditor, is in the final stage of her governmental audit. How should her workpapers be reviewed? **(Page 384)**

a. **There should be a two-stage review—detailed and higher level. [This answer is correct. The review of workpapers near the conclusion of the engagement has two stages: (1) detailed review of the audit work of staff assistants and (2) a higher-level supervisory review.]**

b. The specific requirements laid out in AU-C 220B must be followed. [This answer is incorrect. Authoritative pronouncements establish only broad requirements for supervision and review. AU-C 220B.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.]

c. The audit documentation will be judged sufficient if it just covers who performed the work and when. [This answer is incorrect. 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, according to AU-C 230B.09, the workpapers should indicate *who* reviewed the work and the *date* of the review.]

12. Victoria, a CPA, is tasked by her firm to review the audited financial statements, auditor's report, and other communications and reports for the audit of a local government. Victoria was not part of the audit team. What type of review has she performed? **(Page 387)**

a. A detailed review. [This answer is incorrect. A detailed review should determine whether the audit documentation would permit an experienced auditor who has no previous connection with the engagement to understand (1) the nature, timing, and extent of the auditing procedures performed; (2) the results of the audit procedures and the evidence obtained; (3) the conclusions reached on significant matters; and (4) that the audited financial statements agree or reconcile to the accounting records. This type of review is more detailed than the review Victoria is performing in this scenario.]

b. A supervisory review. [This answer is incorrect. Both AU-C 230B.09 and *Government Auditing Standards* require the workpapers to include evidence of the supervisory review. However, this review is not the type of review that Victoria is performing in the scenario described above because she is not a manager working on the engagement.]

c. **An engagement quality control review. [This answer is correct. Many firms require a review of the audited financial statements, auditor's report, and other communications and reports by someone who has no other responsibilities on the audit. Depending on firm policy, engagement quality control reviews (EQCRs), such as the one Victoria is performing in this scenario, can also include additional procedures, such as looking at checklists or memoranda that document the review and reviewing attorneys' letters and the management representation letter.]**

13. Percy & Sons CPA firm is engaged to audit a local government for the fiscal year ending December 31, 2020. They begin the audit on January 31, 2021. The engagement team has sufficient appropriate audit evidence as of March 15, 2021. The auditor's report is dated March 31, 2021. The report release date is April 15, 2021. On which of the following dates must the firm have detailed, supervisory, and engagement partner's reviews completed? **(Page 388)**

a. January 31, 2021. [This answer is incorrect. This would be too early for the reviews to be performed, as the engagement has not been performed yet.]

b. **March 31, 2021. [This answer is correct. AU-C 220B.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. The authors believe that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review.]

c. April 15, 2021. [This answer is incorrect. According to the clarified auditing standards, this date would be too late for the detailed, supervisory, and engagement partner's reviews. For those engagements for which the firm determines an engagement quality control review (EQCR) is required, the review should be completed prior to the release of the audit report, which is April 15.]

d. June 14, 2021. [This answer is incorrect. The final completion of the audit report file must occur within 60 days of the report release date.]

SUMMARIZING AND EVALUATING

Introduction and Authoritative Literature

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. Additionally, AU-C 450B.11 requires that the individual and combined effects of all uncorrected misstatements be considered to determine whether they are material to the financial statements. Consultation with others on complex technical issues may also be considered at this stage of the audit.

Definition of Misstatements

AU-C 450.04, as amended by SAS No. 134, describes the following characteristics that together comprise the definition of a misstatement:

- A difference between the reported amount, classification, presentation, or disclosure and the amount, classification, presentation, or disclosure required for a financial statement item to be presented fairly in accordance with GAAP.
- Can arise from either error or fraud.
- Includes adjustments of amounts, classifications, presentations or disclosures necessary to achieve fair presentation of financial statements.

Misstatements are also often referred to as audit differences, which include both differences in reported amounts and differences related to disclosures or presentation.

Examples of Misstatements. AU-C 450.A1, as amended by SAS No. 134, provides the following examples of misstatements that may result from error or fraud:

- An inaccuracy occurs in gathering or processing data for inclusion in the financial statements.
- A financial statement amount is omitted.
- A financial statement disclosure is omitted (including inadequate, incomplete, or other disclosures failing to meet disclosure objectives of GAAP).
- A financial statement disclosure is not presented in accordance with GAAP.
- An incorrect accounting estimate results from an oversight or misinterpretation of facts.
- Unreasonable or inappropriate judgments by management occur concerning application of accounting policies or accounting estimates.
- Information is inappropriately classified, aggregated or disaggregated.
- A disclosure is omitted that is necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by GAAP.

The last example includes situations in which information may have to be disclosed to make the information disclosed not be misleading. In some circumstances, literal compliance with the specifically enumerated disclosure requirements of Statements of Governmental Accounting Standards may not be sufficient for the financial statements to be fairly presented. For example, disclosure of the amount of borrowing and lending among related parties during the period may not be sufficient to alert users of the financial statements that a dominant related party is defrauding the other parties to the transactions.

Misstatements versus Normal Closing Entries. The authors believe a distinction is necessary between misstatements and normal closing entries. There are routine entries typically necessary to assist smaller governmental units in the closing process, such as entries to adjust modified accrual basis to full accrual basis. A smaller governmental unit's need for this type of assistance may represent a significant deficiency or material weakness in controls, but the authors believe an auditor may appropriately regard these typical adjustments as not being misstatements as that term is used in AU-C 450B and not significant findings or issues subject to the documentation requirements of AU-C 230B.

Grouping the normal closing entries is more convenient for supervisory review purposes and discussion with management. The normal closing entries have to be agreed to by management and management has to accept responsibility for them. An auditor may prepare a separate memorandum on normal closing entries, or include them with audit adjustments. See the discussion in Lesson 3 related to considerations of AICPA and, if applicable, *Government Auditing Standards* independence requirements.

Categories of Misstatements. AU-C 450B.A6 describes the following terms that distinguish among three categories of misstatements, that 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 including differences related to recognition, measurement, presentation, and disclosure (including selection or application of accounting policies) that are considered unreasonable or inappropriate by the auditor.

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, an inventory purchase recorded using the wrong quantity 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 uncollectible service fees (e.g., water, sanitary) that the governmental unit'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 indicates there is an unacceptable risk the recorded amount is materially misstated.

AU-C 450B establishes requirements and provides guidance on consideration of identified misstatements as the audit progresses, and on evaluating the effect of any uncorrected misstatements on the auditor's conclusion about the appropriate opinion on the financial statements. The required steps for the evaluation of misstatements identified during the audit are as follows:

a. Accumulate identified misstatements (AU-C 450B.05).

b. Communicate accumulated misstatements to management for correction (AU-C 450B.07–.09).

c. Evaluate effect of uncorrected misstatements that remain (AU-C 450B.10–.11).

Also, as the audit progresses, the auditor will have determined whether the identified misstatements indicate a need to revise the initial overall audit strategy and plan (AU-C 450B.06).

Accumulation of Identified Misstatements

AU-C 450B.05 requires the auditor to accumulate misstatements identified during the audit except for those that are clearly trivial. Long before this accumulation requirement was incorporated in auditing standards, auditors had followed the practice of setting an amount below which detected misstatements were not posted to a summary of misstatements. This practice was sometimes called *adjustments passed at the workpaper level* or *passed adjusting entries* (PAJEs). The auditing standards label these adjustments as clearly trivial misstatements and provide an explanation and guidance for considering them.

Clearly Trivial Misstatements. AU-C 450.A2, as amended by SAS No. 134, indicates that *clearly trivial* is not synonymous with *not material*. Clearly trivial misstatements of reported amounts are of a wholly smaller order of magnitude than those determined to be immaterial and are clearly inconsequential, individually or in the aggregate, measured against any criteria of size, nature, or circumstance. In other words, they are inarguably unimportant in either a quantitative or qualitative sense. Similarly, qualitative disclosure or presentation misstatements are of a wholly different nature than those determined to be material judged by any criteria of nature or circumstance.

Accumulation of Misstatements of Reported Amounts. Misstatements include both differences in reported amounts of financial statement items and also differences in financial-statement classifications, presentation or disclosures. The accumulation of audit differences in reported amounts that are not clearly trivial can be accomplished by posting to a workpaper summarizing the differences. This form facilitates the accumulation of individual audit differences in reported amounts by important totals and subtotals for individual opinion unit financial statements: total assets, total liabilities, and fund balance/net position for the financial position statements and the resource flows statements.

Accumulation of Misstatements in Disclosures. AU-C 450.A4, as added by SAS No. 134, points out that misstatements in disclosures that are not clearly trivial also have to be accumulated in order to evaluate the effect of the misstatements on the relevant disclosures and the financial statements of an opinion unit taken as a whole. An auditor decides what misstatements in disclosures are to be evaluated by considering their size, nature, and circumstances. Misstatements in disclosures are evaluated primarily by considering their nature or circumstances (that is, their qualitative aspects). AU-C 450B.A5 observes that misstatements in the nature or circumstances of disclosures cannot be added together in the way misstatements of reported amounts are summarized, but that the auditor is still required by AU-C 450B.11 to evaluate those misstatements both individually and in the aggregate to evaluate their materiality. An auditor may prepare a workpaper memorandum that identifies all the misstatements in disclosures and the qualitative considerations to evaluate them individually and collectively with other misstatements.

Communication and Correction of Misstatements. AU-C 450B.07 requires the auditor to communicate to management on a timely basis misstatements accumulated during the audit, other than clearly trivial ones. AU-C 450B.A6 suggests that distinguishing the categories of misstatements identified is beneficial to the communication with management and those charged with governance. AU-C 450B.07–.09 also requires the following related to the communication and correction of misstatements:

- Ask the appropriate level of management to correct accumulated misstatements.
- After the detection of a misstatement, the auditor may request management to examine account balances, transactions classes, or disclosures and make appropriate corrections. 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 these 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 qualitative considerations. The auditor should also consider the implications for the audit report. In addition, as discussed in Lesson 3, uncorrected misstatements are significant audit findings under AU-C 260B.13 and should be communicated to those charged with governance.

When communicating accumulated misstatements, AU-C 450B.A9 indicates that the appropriate level of management is the one that has responsibility and authority to evaluate misstatements and take the necessary corrective action. The authors recommend that management be strongly encouraged to correct all identified misstatements, including those communicated by the auditor. AU-C 450B.A11 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 450B.A10, laws or regulations might specifically prohibit a communication or other action that might prejudice an ongoing investigation by an appropriate authority.

For smaller governmental units, management will likely have corrected all nontrivial misstatements and remaining uncorrected misstatements will be limited. Generally, management would record factual misstatements. For judgmental misstatements, management may 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 may examine the population to determine the actual misstatements in the population.

Evaluation of Uncorrected Misstatements

AU-C 450B.10 requires that before evaluating the effect of uncorrected misstatements, the auditor reassesses whether the materiality judgments made in planning, and possibly revised as the audit progressed, remain appropriate. For example, the governmental unit's financial results after misstatements have been communicated to management and corrected may be significantly different than the amount considered in establishing planning materiality.

After reassessing materiality and communicating accumulated misstatements to management for consideration and correction, some uncorrected misstatements may remain. AU-C 450B.11 requires the auditor to determine whether uncorrected misstatements are material individually or in the aggregate by considering the size, nature, and circumstances of the misstatements and the effect of prior-period uncorrected misstatements in relation to classes of transactions, account balances, or disclosures and the financial statements of an opinion unit taken as a whole. SLG, Paragraph 15.03, clarifies that in the context of a governmental audit, the evaluation of whether the financial statements as a whole are free of material misstatement is done by opinion unit. This is because the auditor's report on the basic financial statements provides a separate opinion on each opinion unit.

Evaluating Uncorrected Misstatements of Reported Amounts. AU-C 450.A22, as clarified by SAS No. 134, indicates that each individual misstatement of an amount is considered to evaluate the effect on relevant classes of transactions, account balances, or disclosures, including whether for that particular item the materiality level has been exceeded. Both the quantitative and qualitative aspects of materiality are considered for each individual misstatement.

In evaluating the materiality of uncorrected reported amounts, an auditor considers their size, nature, and circumstances of occurrence. The size of the misstatement, as a starting point, may be compared to the materiality level established in planning for the financial statements of an opinion unit taken as a whole, and the levels for particular classes of transactions, account balances, or disclosures. If planning levels have been revised because the auditor concluded lower levels were appropriate before completing the audit, then those lower levels would be used. An auditor may also decide to use a different benchmark or percentage than that used in planning based on information obtained during the audit. An auditor then considers whether qualitative considerations would cause amounts below this size to be material. The authors stress that the evaluation of materiality of uncorrected reported amounts has to consider the combined effect of qualitative and quantitative factors. Making separate judgments about the quantitative effect of the size of a misstatement and then considering individual qualitative factors from a published list one at a time is not consistent with accounting or auditing standards on materiality.

To meet requirements of AU-C 450B.11 to determine whether uncorrected misstatements are material in the aggregate, an auditor typically prepares a summary of misstatements of reported amounts. The techniques and forms used in the aggregation of misstatements of reported amounts is explained later in this section.

Evaluating Uncorrected Misstatements of Qualitative Disclosures. Misstatements in qualitative disclosures may be considered material either individually or in combination with other misstatements.

AU-C 450.A23, as added by SAS No. 134, indicates that each individual misstatement of a qualitative disclosure has to be considered both in relation to the effect on the relevant individual disclosure and the overall effect on the financial statements of an opinion unit taken as a whole and provides the following examples of such misstatements that may be material:

- Information about the objectives, policies, and processes for managing capital that is incomplete or inaccurate.
- Information about events or circumstances leading to an impairment loss that is omitted.

- Incorrect description of a significant accounting policy.
- Inadequate information on the sensitivity of an exchange rate.

When considering the combined effect of misstatements of qualitative disclosure, AU-C 450.A24, as added by SAS No. 134, indicates the auditor may consider whether:

- Several identified misstatements are relevant to the same matter and collectively affect users' understanding of that matter.
- Identified misstatements are pervasive or recurring.

Additional Examples of Qualitative Considerations. An auditor's overall judgment about whether a misstatement is material is 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 450B.A28 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 nature of misstatements in qualitative disclosures dictates that the evaluation of materiality is based on qualitative factors. Following are several examples of qualitative factors that may be considered in evaluating the materiality of the effect of misstatements on transaction classes, account balances, and disclosures.

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 opinion unit financial statements. Other misstatements may be pervasive to the financial statements (that is, affecting numerous financial statement amounts, subtotals, or totals).

b. *Significance of the Financial Statement Element or Portion of the Governmental Unit's Activities Affected by the Misstatement.* For example, a misstatement affecting service revenue (e.g., water, sanitation) for a proprietary fund 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 activities that has been represented as significant to the governmental unit's future activities might be more material than a misstatement of the same amount affecting another portion of the governmental unit's activities.

c. *Effect on Compliance.* A misstatement might affect the governmental unit's compliance with loan covenants, other contractual or grant agreements, or regulatory provisions. For example, a misstatement might be material if correcting it would result in a violation of a grant requirement or reveal a default under a debt covenant.

d. *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.

e. *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.

f. *Effect on Ratios.* A misstatement may alter ratios used to evaluate the governmental unit's financial position, financial performance, or cash flows.

g. *Effect on Segment Information.* A misstatement of allocations or other amounts may alter segment information presented in the financial statements. For example, allocation of expenses may be altered to avoid going over budget

h. *Known Previous Communications to Users.* A misstatement may significantly alter information previously communicated to users. For example, the misstatement may impact information on bond official statements, grant applications, or budgets that may not have been approved if information was not misstated.

i. *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 governing board.

j. *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 governmental unit.

k. *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, information provided in the MD&A or the statistical section (e.g., financial trend, revenue or debt capacity, demographic and economic information, or operating information).

l. *Sensitivity of the Circumstances.* For example, implications of misstatements involving fraud, possible instances of noncompliance with laws or regulations, violations of contractual provisions or grant agreements, or conflicts of interest could be significant.

m. *The Effects of Misclassifications.* The effects of misclassifications could be significant to the financial statement users, for example, a misclassification between general fund or special revenue fund expenditures or restricted and unrestricted net position.

n. *Significance of the Misstatement or Disclosures in Relation to Reasonable User Needs* For example, a misstatement that affects the debt service requirements or legal debt margin could be material to citizens in a bond election.

o. *Character of the Misstatement.* Some misstatements, 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 precise adjustments (sometimes referred to as "hard") with much less precise adjustments (sometimes referred to as "soft"). For example, a large cutoff error in recognizing tax revenue might be individually material even if it could be offset by an estimated overage in the allowance for doubtful accounts receivable. 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.

p. *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 or intentional decision not to follow GAAP.

q. *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.

r. *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.

s. *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 how items are reflected in the financial statements.

t. *Risk That Possible Additional Undetected Misstatement Would Affect the Evaluation.* See the discussion of further misstatement.

The items in the above list are only examples of qualitative factors that may be pertinent to the auditor's evaluation of materiality. The auditor should consider additional qualitative factors that may exist. 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 opinion unit financial statements.

Matters such as public interest, accountability, integrity, and ensuring effective legislative oversight may also affect the assessment of whether an item is material—especially for matters that relate to compliance with laws or regulations.

Risk of Possible Undetected Misstatements and Overall Evaluation. AU-C 450B.A8 indicates that even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the opinion unit financial statements to be materially misstated, the auditor recognizes that there is a risk that the opinion unit financial statements may be materially misstated due to further undetected misstatements. If combined uncorrected misstatements are very close to the amount an auditor considers material to the financial statements of an opinion unit taken as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers $20,000 to be material and uncorrected misstatements are $5,000, the risk of further misstatement of $15,000 may be considered acceptably low. If combined uncorrected misstatement is close to $20,000, the risk may be considered unacceptable. In that case, the auditor needs to perform additional procedures or determine that the entity appropriately adjusts the opinion unit financial statements.

Evaluating the Existence of Fraud

According to AU-C 240B.35, if the auditor identifies a misstatement, the auditor should evaluate whether it is indicative of fraud and the implications for the audit, including the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations. 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 240B.36 indicates that the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and the effect on the nature, timing, and extent of audit procedures. Additionally, the auditor should consider whether it indicates collusion involving employees, management, or third parties when reconsidering the evidence previously obtained. 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. Lesson 3 discusses the auditor's additional responsibilities when evidence suggests fraud has occurred.

AU-C 450.A29, as amended by SAS No. 134, notes that misstatements in disclosures may also be indicative of fraud and offers the following examples:

- Management's biased judgments result in misleading disclosures.
- To obscure proper understanding, extensive duplicative or uninformative disclosures are included in the financial statements.

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 the case AU-C 240B.38 further indicates that auditors should determine their 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). Withdrawal requires the auditor to (a) discuss the withdrawal and the reasons for it with the appropriate level of management and those charged with governance, and (b) determine whether there is a professional or legal requirement to report the withdrawal and the reasons for it, to the party who engaged the auditor, 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. AU-C 240B.A65 suggests that auditors considering withdrawal should consult with legal counsel.

Evaluating Noncompliance, Waste, and Abuse—*Government Auditing Standards* Requirements

Government Auditing Standards require auditors to design their audits to provide reasonable assurance of detecting noncompliance with the provisions of contracts or grant agreements that could have a material effect on the financial statements. Paragraph 6.15 of the Yellow Book explains that the AICPA requirements pertaining to the auditors' responsibilities for laws and regulations also apply to consideration of compliance with provisions of contracts or grant agreements.

Government Auditing Standards also establish specific requirements related to waste or abuse. Paragraph 6.20 of the Yellow Book states that auditors may consider whether and how to communicate fraud and abuse matters if they become aware of them. Auditors may discover that waste or abuse are indicative of fraud or noncompliance with provisions of laws, regulations, contracts, and grant agreements.

The Yellow Book has specific requirements for communicating noncompliance and fraud. These communication requirements are discussed in Lesson 3.

Documentation Requirements

In order to evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. AU-C 450B.12 requires the auditor to 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 should allow 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 opinion unit financial statements.
- Consider the qualitative factors that are relevant to the auditor's consideration of whether misstatements are material.

Uncorrected Misstatements Related to prior Periods

AU-C 450B.11 requires the auditor to determine whether uncorrected misstatements are material individually or in the aggregate. The required determination includes the effect of uncorrected misstatements related to prior periods on relevant classes of transactions, account balances, or disclosures and the financial statements of an opinion unit taken as a whole. In practice, prior-period uncorrected misstatements have been typically referred to as prior year waived adjustments.

Summary of Audit Differences

In a governmental audit, the auditor needs to combine, or aggregate, uncorrected misstatements at the opinion unit level. According to AU-C 450B, the auditor needs to aggregate misstatements in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the opinion unit financial statements, they materially misstate those opinion unit financial statements taken as a whole. This simply means that, in addition to considering the materiality of individual misstatements, the auditor needs to consider their combined effect on important opinion unit totals or subtotals; e.g., total assets, fund equity, excess of revenue over expenditures, etc. Using an audit difference evaluation form for summarizing audit differences and considering their effect on the appropriate opinion unit allows the auditor to evaluate the materiality of misstatements both individually and in combination. A separate form should be prepared for each opinion unit.

To illustrate, assume that at the end of the prior period, the accrued vacation leave liability was understated by $10,000, and the client waived an adjustment to correct the misstatement. As a result, expenditures were understated and activity statements were overstated by $10,000 at the end of the prior period. Assume also that at the end of the current period, the accrued vacation leave liability is understated by $15,000. Under the rollover method, the current-period financial position statements will be misstated by $15,000 while activity statements will be misstated by only $5,000 (the net effect of the $15,000 current-period liability understatement and reversal of the $10,000 prior-year understatement). Under the iron curtain method, the prior-year waived adjustment on current period activity statements would not be considered. The liability and expenditures in the current period would both be understated by $15,000. In other words, the $15,000 effect of correcting the financial position statements misstatement at the end of the current period would be used in evaluating the activity statements 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 450B.A30 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 financial position statement misstatements could accumulate over multiple periods to an amount that would have a material effect on the change in fund balance/net position 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 (for example, the impact of a reversal) on the change in fund balance/net position of misstatements detected in prior periods. Practice for governmental unit engagements currently accepts either the rollover or iron curtain method.

Across-fund Testing. If audit differences are identified as a result of across-fund testing, the authors believe that the projected misstatements from a substantive sampling procedure should be allocated on a pro rata basis to the funds that are involved. For example, auditors of a municipality may decide that it would be more efficient to audit cash disbursements of the General Fund and the Water and Sewer Fund using across-fund testing. In that case, they would allocate the projected misstatements based on the ratio of factual misstatements of each of those funds to total factual misstatements of the funds. Assuming that the General Fund had 60% of the factual misstatements while the Water and Sewer Fund had 40%, the projected audit difference would be allocated 60% to the General Fund and 40% to the Water and Sewer Fund. Factual misstatements that were identified in the across-fund test would be reported in the funds where the actual expenditures were incurred.

Applying the Rollover and Iron Curtain Methods. The rollover method considers the relationship between net assets and the change in fund balance/net position. The effect of a misstatement in opening fund balance/net position usually has the opposite effect on the change in fund balance/net position, and a misstatement in ending fund balance/net position usually has the same effect on the change in fund balance/net position. 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, the change in fund balance/net position (and fund balance/net position) 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 change in fund balance/net position. However, if the client did not accrue for the paid vacation leave earned in the current year, the effect on change in fund balance/net position in the current year might be immaterial when taking into account the effect of the prior-year misstatement that was not adjusted for in the prior year.

Dual Approach Recommended. The authors believe 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 accrued vacation leave liability example from above, 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 the change in fund balance/net position 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 fund balance/net position 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, the authors recommend that in quantifying the effect of misstatements, both the rollover and iron curtain methods be used by the auditor. The auditor should propose an adjustment to the financial statements if either method indicates a material misstatement of the current year financial statements. In a government engagement, the governmental unit's officials typically correct all misstatements discovered in the audit. Thus, uncorrected prior years' misstatements usually do not complicate the summarization and evaluation of misstatements.

Workpaper Format for Summary. A variety of workpaper formats could be used to summarize audit differences for consideration of their combined effect on the financial statements. The only condition is that the materiality of misstatements should be evaluated both individually and in the aggregate, in the context of individual opinion units and conclude on whether they materially misstate the financial statements of an opinion unit taken as a whole. It is necessary to combine individually immaterial misstatements to evaluate the materiality of the effect on the financial statements taken as a whole.

When using certain audit difference evaluation forms, such as the one provided in *PPC's Guide to Audits of Local Governments*, the effects of unadjusted audit differences from prior years (that is, the turnaround effect of prior year misstatements) can only be posted to the current year change in fund balance/net position. The effects, if any, of prior year unadjusted audit differences that impact current year assets, liabilities, or ending fund balance/net position are reflected as current year audit differences on the form. This approach allows the auditor to track misstatements with ongoing financial position statement implications from period to period.

Consultation on Technical Issues

The review of workpapers, particularly the summarization and evaluation of uncorrected misstatements, may indicate the need to consult with someone not involved in the engagement on complex technical issues. 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 220B.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. The extent of specialization varies with firm size and individual firm preference. Naturally, the smaller a firm, the less likely there is a specialist available for consultation within the firm. On particularly complex matters, outside consultation may be advisable. SQCS No. 8 (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.

AU-C 220B.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 220B.A20 notes that members of the audit engagement team also have responsibilities 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 220B.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.

The AICPA has a "technical hotline" that can be consulted on complex accounting and auditing issues. It provides advice on treatment of auditing and financial reporting issues related to governmental and nongovernmental engagements. The toll-free number for this service is (888) 777-7077. In a Single Audit, the auditor is encouraged to consult with the cognizant or oversight agency for audit on technical matters.

SELF-STUDY QUIZ

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

14. Which of the following most accurately describes a *projected misstatement*?

    a. A misstatement arising from judgments made by management related to accounting estimates believed by the auditor to be unreasonable.

    b. A misstatement resulting from the auditor's best estimate of misstatement extrapolated to entire populations when using sampling.

    c. A misstatement that arises due to the selection or application of an accounting principle by management that the auditor considers inappropriate.

    d. A misstatement about which there is no doubt.

15. Auditors are required to accumulate misstatements identified during the audit **except** for those misstatements that are considered to be which of the following?

    a. Indicative of potential fraud.

    b. Arise from error.

    c. Not material.

    d. Clearly trivial.

16. Which of the following is accurate regarding the communication and correction of misstatements?

    a. The auditor has the responsibility for the correction of any accumulated misstatements.

    b. After detecting a misstatement involving an estimate, the auditor reviews the assumptions and methods used in its development.

    c. Management should gain an understanding of the auditor's reasons if the auditor decides not to correct misstatements.

    d. Uncorrected misstatements are a significant finding and the auditor should report them to those charged with governance.

17. Glenn, a CPA, just finished auditing a government client. Which of the following should Glenn include in his documentation for the engagement?

    a. A conclusion about whether the accumulated misstatements cause the financial statements to be materially misstated.

    b. Whether management corrected misstatements discovered during the audit.

    c. A list of material misstatements that were accumulated by the auditor.

    d. The amount below which misstatements are considered immaterial.

SELF-STUDY ANSWERS

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

14. Which of the following most accurately describes a *projected misstatement*? **(Page 396)**

    a. A misstatement arising from judgments made by management related to accounting estimates believed by the auditor to be unreasonable. [This answer is incorrect. Under AU-C 450B.A6, this is a *judgmental misstatement*.]

    b. **A misstatement resulting from the auditor's best estimate of misstatement extrapolated to entire populations when using sampling. [This answer is correct. According to AU-C 450B.A6, this is a *projected misstatement*.]**

    c. A misstatement that arises due to the selection or application of an accounting principle by management that the auditor considers inappropriate. [This answer is incorrect. Under AU-C 450B.A6, this is a *judgmental misstatement*.]

    d. A misstatement about which there is no doubt. [This answer is incorrect. Under AU-C 450B.A6, this is the definition of a *factual misstatement*.]

15. Auditors are required to accumulate misstatements identified during the audit **except** for those misstatements that are considered to be which of the following? **(Page 396)**

    a. Indicative of potential fraud. [This answer is incorrect. 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. As such, this is not the type of misstatement excepted from accumulation.]

    b. Arise from error. [This answer is incorrect. AU-C 450.04, as amended by SAS No. 134, describes certain characteristics that together comprise the definition of a misstatement, one of which is that it can arise from either error or fraud. This situation would not be excepted from accumulation.]

    c. Not material. [This answer is incorrect. AU-C 450.A2, as amended by SAS No. 134, indicates that *clearly trivial* is not synonymous with *not material*. If a misstatement is considered not material, the auditor is required to accumulate it.]

    d. **Clearly trivial. [This answer is correct. AU-C 450B.05 requires the auditor to accumulate misstatements identified during the audit except for those that are clearly trivial. Clearly trivial misstatements of reported amounts are of a wholly smaller order of magnitude than those determined to be immaterial and are clearly inconsequential, individually or in the aggregate, measured against any criteria of size, nature, or circumstance. In other words, they are inarguably unimportant in either a quantitative or qualitative sense.]**

16. Which of the following is accurate regarding the communication and correction of misstatements? **(Page 397)**

    a. The auditor has the responsibility for the correction of any accumulated misstatements. [This answer is incorrect. AU-C 450B.07–.09 requires the auditor to ask the appropriate level of *management* to correct accumulated misstatements.]

    b. After detecting a misstatement involving an estimate, the auditor reviews the assumptions and methods used in its development. [This answer is incorrect. 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.]

c. Management should gain an understanding of the auditor's reasons if the auditor decides not to correct misstatements. [This answer is incorrect. If management (not the auditor) 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 qualitative considerations.]

d. **Uncorrected misstatements are a significant finding and the auditor should report them to those charged with governance. [This answer is correct. Uncorrected misstatements are significant audit findings under AU-C 260B.13 and should be communicated to those charged with governance.]**

17. Glenn, a CPA, just finished auditing a government client. Which of the following should Glenn include in his documentation for the engagement? **(Page 402)**

a. A conclusion about whether the accumulated misstatements cause the financial statements to be materially misstated. [This answer is incorrect. According to AU-C 450B.12, the auditor's documentation should include 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. Under the guidance, this conclusion is limited to uncorrected misstatements, and would not include accumulated misstatements that were corrected by management.]

b. **Whether management corrected misstatements discovered during the audit. [This answer is correct. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers. AU-C 450B.12 requires the auditor to prepare documentation that covers several specific items related to misstatements, one of which is whether misstatements accumulated by the auditor during the audit were corrected by management.]**

c. A list of material misstatements that were accumulated by the auditor. [This answer is incorrect. Under AU-C 450B.12, the auditor should document *all* misstatements that he or she accumulated during the audit, not just those that are material.]

d. The amount below which misstatements are considered immaterial. [This answer is incorrect. AU-C 450B.12 states that the auditor should document the amount below which misstatements would be regarded as *clearly trivial* (which does not mean the same thing as *not material*).]

Lesson 3: Drafting, Communication, and Subsequent Discoveries

INTRODUCTION

Lesson 3 discusses some of the final aspects of concluding an audit engagement. First, this lesson takes a look at drafting the financial statements and the auditor's report. Next, this lesson takes a look at the different communications that must be made at the end of an audit. Those include communicating internal control related matters, communicating with those charged with governance, communicating fraud and violations of laws and regulations, management letters, and the engagement summary memorandum. Finally, this lesson concludes with a brief discussion of subsequent events or facts that are discovered after the date of the auditor's report. Guidance related specifically to governmental audits is included where applicable.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify requirements for drafting the financial statements and auditor's report, and communicating internal control related matters.
- Assess issues related to communicating with those charged with governance, communication of fraud and violations of laws and regulations, requirements for preparing management letters and the ESM, and courses of action for subsequent discovery of matters after the report date.

DRAFTING THE FINANCIAL STATEMENTS AND AUDITOR'S REPORT

In many governmental 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*.) This is an accounting service rather than a part of audit responsibility, but one that the client may expect and value. 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. For the auditor to remain independent, management should agree to accept this 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. The 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. Internal control issues related to the auditor's involvement in financial statement preparation are discussed in detail in the next section.

Government Auditing Standards Requirements

Under the Yellow Book, drafting the financial statements is considered to be a nonaudit service that should be evaluated under the Yellow Book's conceptual framework for independence. These same principles apply to assistance with preparing information accompanying the financial statements, including required supplementary information.

Consideration of Major Funds

Governmental financial statements include both government-wide financial statements and fund financial statements. The fund financial statements are presented by fund category with the reporting emphasis on individual major funds. When concluding the audit, the auditor should review the determination of major funds after all adjustments and reclassifications have been made to the financial statements to determine whether (a) all required major funds are separately displayed in the financial statements and (b) the auditor adequately addressed them during the audit.

Notes to the Financial Statements

The notes to financial statements are an integral part of the statements, and the information is tested when the related financial statement area is tested. Even the most experienced auditors find it necessary to use some aid to remind them of the multitude of required disclosures. The authors recommend the use of a disclosure checklist.

Required Supplementary Information (RSI)

GAAP requires governments to present certain supplementary information along with, but not included in, the basic financial statements.

Auditors' Procedures for RSI. The AICPA Auditing Standards Board establishes standards for auditors reporting on RSI, including RSI required by the GASB. AU-C 730B, *Required Supplementary Information*, states that the auditor should apply the following procedures to RSI:

- Inquire of management about the methods of preparing the information (including whether its measurement and presentation comply with standards, whether changes have been made in measurement or presentation methods, and whether any significant assumptions or interpretations underlie the measurement or presentation).
- Compare the RSI for consistency with management's responses to inquiries, the financial statements, and other knowledge obtained during the audit.
- Obtain certain representations about RSI in management's representation letter.
- If the above procedures could not be completed, consider whether management contributed to the inability to complete them and, if the inability to complete the procedures was due to significant difficulties encountered in dealing with management, inform those charged with governance.

Comprehensive Annual Financial Report and GFOA Certificate of Achievement

If the governmental unit issues a comprehensive annual financial report (CAFR), numerous other statements and information will accompany the financial statements and RSI. The basic components of a CAFR are prescribed in GASB Cod. Sec. 2200.105. Exhibit 3-1 lists the content of a CAFR. The auditor's reporting responsibility for the different parts of a CAFR can vary under the terms of the engagement and will significantly affect audit scope.

Exhibit 3-1

Content of a Comprehensive Annual Financial Report (CAFR)

1. Introductory Section

   (Table of contents, letter(s) of transmittal, and other material deemed appropriate by management.)

2. Financial Section

   a. Auditor's Report.

   b. Management's Discussion and Analysis.

   c. Basic Financial Statements.

   d. Required Supplementary Information (other than MD&A).

   e. Combining Statements and Individual Fund Statements and Schedules.

(1) Combining statements—by fund type—where a primary government (including its blended component units) has more than one internal service fund, fiduciary fund, or fiduciary component unit or more than one nonmajor governmental or enterprise fund.

(2) Combining statements—for discretely presented component units—where the reporting entity has more than one nonmajor component unit. Fund financial statements for individual component units are also required if the information is not available in separately issued financial statements of the individual component unit.

(3) Individual fund statements—where a primary government (including its blended component units) has only one nonmajor fund of a given fund type or if necessary to present prior-year and budgetary comparisons not presented in required supplementary information.

(4) Schedules.

(i) Schedules necessary to demonstrate compliance with finance-related legal and contractual provisions.

(ii) Schedules to present information spread throughout the statements that can be brought together and shown in greater detail (for example, taxes receivable, including delinquent taxes; long-term debt; investments; and cash receipts, disbursements, and balances).

(iii) Schedules to present greater detail for information reported in the statements (for example, additional revenue sources detail and object of expenditure data by departments).

3. Statistical Section—under GASBS No. 44 (unless inapplicable in the circumstances)

a. Financial Trends Information, with four tables required:

(1) Net position.

(2) Changes in net position.

(3) Governmental fund balances.

(4) Changes in governmental fund balances.

b. Revenue Capacity Information, with presentation of four types required:

(1) Revenue base.

(2) Revenue rates.

(3) Principal revenue payers.

(4) Property tax levies and collections (if property tax revenues are a significant own-source revenue).

c. Debt Capacity Information, with four types required:

(1) Ratios of outstanding debt.

(2) Direct and overlapping debt.

(3) Debt limitations.

(4) Pledged-revenue coverage.

d. Demographic and Economic Information, with two schedules required:

(1) Information about principal employers.

(2) Information about demographic and economic indicators (including population, total personal income, per capita personal income, and unemployment rate).

e. Operating Information, with three types of information required:

(1) Information about government employees.

(2) Operating indicators.

(3) Capital assets.

GASBS No. 44. GASBS No. 44, *Economic Condition Reporting: The Statistical Section an amendment of NCGA Statement 1*, requires the five broad categories of information listed in item 3 of Exhibit 3-1. The GASB encouraged governments to apply the new standard retroactively to the date when they adopted GASBS No. 34. Extensive guidance on GASBS No. 44 is provided in chapter 9 of GASB's *Comprehensive Implementation Guide*. That guide can be ordered through the GASB website—**www.gasb.org**. The guide is also available at **tax.thomsonreuters.com** for readers who subscribe to the GASB material on Checkpoint.

The GASB does not require governments to prepare a CAFR or to prepare and present a statistical section. However, GASBS No. 44 applies when a government chooses to present a statistical section with its basic financial statements (generally as part of a CAFR). Governments may present some, but not all, of the statistical information required by GASBS No. 44. When that is the case, they should not refer to that portion of the financial report as a statistical section. See detailed guidance on preparing the statistical section of a CAFR in accordance with GASBS No. 44 in *PPC's Guide to Preparing Governmental Financial Statements*.

To encourage high quality financial reporting, the Government Finance Officers Association (GFOA) has a voluntary program under which a governmental unit may submit its CAFR for a certificate of achievement for excellence in financial reporting. The GFOA also has developed checklists for CAFRs for school districts, cash and investment pools, pension and other postemployment benefits (OPEB) systems, and stand-alone-business-type activities, such as individual enterprise funds, and special districts with only enterprise funds. Checklists used by the GFOA's review committee can be downloaded from the GFOA's website at **www.gfoa.org**.

Sources of Financial Reporting Illustrations

Auditors may find the following to be useful sources of illustrative financial statements and note disclosures, as well as schedules and statistical data presented in a CAFR:

- *Codification of Governmental Accounting and Financial Reporting Standards*, published by the GASB. Section 2200.902 of the GASB Codification illustrates the basic financial statements, required supplementary information, and combining statement supplementary information. Additional basic financial statements are illustrated in Sections 2200.903–.904 and .908. The Codification can be ordered through the GASB website—**www.gasb.org**. The Codification is also available at **checkpoint.riag.com** for readers who subscribe to the GASB material on Checkpoint.

- *PPC's Guide to Preparing Governmental Financial Statements* is a manual for preparing governmental financial statements that are both in accordance with GAAP and professional in appearance. It presents the requirements of the authoritative literature and provides numerous illustrations. It is best described as a governmental GAAP guide supplemented with additional practical guidance and real-life examples. This *Guide* can be ordered by calling (800) 431-9025 or visiting our website at **tax.thomsonreuters.com**.

- *PPC's Governmental Financial Statement Illustrations and Trends* provides more than 650 pages of actual government-wide and fund financial statements, notes, and management's discussions and analysis for governmental units. This *Guide* can be ordered by calling (800) 431-9025 or visiting our website at **tax.thomsonreuters.com**.

- *Governmental Accounting, Auditing and Financial Reporting* (GAAFR), published by the GFOA, includes reporting guidance and a template of an illustrative CAFR. It can be ordered from the GFOA, via the internet at **www.gfoa.org**.

Drafting the Auditor's Report

The auditor's report is drafted after considering any scope limitations, GAAP departures, or other matters that should be reported. After the financial statements and auditor's report have been drafted, the auditor typically discusses them with officials of the governmental unit. (Sometimes the engagement contract specifically requires an exit conference.) At this meeting the emphasis is on complex or unusual accounting principles or other matters in the financial statements, including any unresolved issues of presentation or disclosure. (This is necessary so that the client can take responsibility for the financial statements, allowing the auditor to remain independent of the client.) Any modifications of the auditor's report would also be emphasized. (Such problems need to be discussed with the client as early as practicable to allow time for consideration and resolution.) The auditor should also discuss any problems identified during the audit, such as deficiencies in internal control, violations of budget or grant requirements, and errors or fraud. Suggestions for improvement might be discussed, as well as other matters such as the final audit fee, other advisory services the accounting firm might suggest, final arrangements for report distribution, and all matters he or she considers significant. In addition, audit guidance imposes certain communication responsibilities, as discussed in the sections that follow.

COMMUNICATION OF INTERNAL CONTROL RELATED MATTERS

Introduction and Authoritative Literature

AU-C 265B, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies 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 265B, as amended by AU-C 940B, 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 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."

Identifying Control Deficiencies

In a GAAS audit, an auditor is not required to perform procedures to identify deficiencies in internal control. However, AU-C 265B.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.

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 (a) missing or (b) not properly designed so that even if it 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 lacks the necessary authority or qualifications to perform it effectively.

Evaluating Identified Deficiencies

If the auditor has identified one or more deficiencies in internal control, AU-C 265B.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 265B.10 states that the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. Considering the views of a prudent official is discussed later in this section.

Indicators of Material Weaknesses. According to AU-C 265B.A11, 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 265B.A11 identifies these factors only as *indicators of material weaknesses*, the authors believe 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 265B.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. A reasonable possibility exists when the chance of the future event or events occurring is more than remote.

Factors Affecting the Magnitude of a Potential Misstatement. While AU-C 265B 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 265B.

If a factual misstatement has occurred, it 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 265B.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 example, if there is a control deficiency related to segregation of duties over grants receivable, and the recorded amount is $250,000, that is the most grants receivable could be overstated. However, grants 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 discussed above, AU-C 265B does not provide any additional insight for determining the magnitude of a potential misstatement.

AU-C 320B, *Materiality in Planning and Performing an Audit*, elaborates on that guidance in AU-C 320.A13, as amended by SAS No. 134, 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, regulations, or GAAP requirements affect users' expectations about how certain information should be measured or disclosed (for example, related party transactions, the remuneration of management and those charged with governance, or a sensitivity analysis for a fair value estimate with high estimation uncertainty).
- Key disclosures for the industry environment in which the entity operates.
- Whether attention is focused on a particular aspect of the entity's operations that are separately disclosed in the financial statements (for example, a component unit).

The authors believe auditors also could consider circumstances such as the following when evaluating the materiality of a potential misstatement caused by an identified control deficiency, including whether the deficiency:

- Is quantitatively small in relation to the entity's change in net position for the current period, but is significant to the overall trend of earnings (for example, a misstatement that reverses a downward trend of revenues).
- Results in events or circumstances that could materially affect the opinion unit financial statements due to qualitative considerations. For example, a small illegal payment 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 (i.e., misstatements that affect numerous financial statement amounts, subtotals, totals, or disclosures).

  Affects numerous financial statement amounts, subtotals, or totals.
- Masks a change in revenues or other trends, especially in the context of general economic conditions.
- Affects the entity's compliance with debt covenants, other contractual agreements, or regulatory provisions (for example, a misstatement that would mask a default of a debt covenant).
- Is 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 240B, *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 significant disclosures related to a small account balance.

In summary, the auditor needs to draw on his or her knowledge and understanding of the client to identify all of the qualitative factors that might influence the judgment about the materiality of a potential misstatement and, thus, judgments about the severity of an identified control deficiency. It is also 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, the authors encourage auditors to remember that the materiality of a potential misstatement affects only whether a deficiency is communicated to management and those charged with governance. Unlike judgments about an actual misstatement, 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 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, the authors recommend 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 chance of the future event or events occurring is more than remote. AU-C 265.A8, as amended by SAS No. 135, 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 accounts, classes of transactions, disclosures, and assertions involved (for example, suspense accounts may present more risk).
- The cause and frequency of the exceptions detected as a result of the deficiency, or deficiencies, in internal control.
- 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 of the deficiency.
- The importance of the controls to the financial reporting process—for example, whether the deficiency involves 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 unusual transactions.
  - The period-end financial reporting process (such as controls over nonrecurring journal entries).

PPC's Process for Evaluating the Severity of Deficiencies. When evaluating the severity of an identified control deficiency under AU-C 265B, the authors believe auditors generally begin by considering whether an identified deficiency is considered a material weakness. If it is not, the auditor will consider its severity to determine whether to communicate it to management and others as a significant deficiency. Specifically, the authors recommend the following approach to the process:

a. For an identified deficiency, determine whether it is a material weakness by considering whether (1) the potential misstatement could result in a material misstatement to the financial statements and (2) 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.

b. 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.

c. 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 265B.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 265B.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 account balance or disclosure, relevant assertion, or component of internal control.

An auditor considers several control deficiencies, which individually are 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 to combine control deficiencies might cause the auditor to consider them a significant deficiency or material weakness. Exhibit 3-2 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 3-2

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 grants receivable transactions were not properly recorded (the transactions were not material, either individually or in the aggregate).
- Account balances affected by the improperly recorded grants receivable transactions were not reconciled on a timely basis.
- The governmental unit has inadequate segregation of duties over IT access controls related to the grants receivable function.

Because each of these deficiencies affects the same accounts, these significant deficiencies, when considered together, represent a reasonable possibility that a material misstatement could occur and not be prevented or detected and corrected. Thus, the auditor would likely conclude that, in combination, these significant deficiencies represent a material weakness.

In another example, assume the 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 governmental unit's lack of adequate reviews and approvals. While each of these control deficiencies relates 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 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 265B.10 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?

The authors believe 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 operations and the needs of the users of the financial statements. In a governmental environment, evaluating the severity of the deficiency through the eyes of a regulatory or oversight agency might be the most practical approach.

Finally, it is important to understand that the prudent official test is used only to gauge whether the judged severity of a control deficiency is greater than, but never lower than, the auditor's preliminary judgment.

Practice Issues

Auditors frequently have questions about whether certain matters, such as assisting with preparation of the client's financial statements, represent control deficiencies. The following paragraphs discuss certain related practice issues:

- If the auditor prepares the financial statements, does the client automatically have a control deficiency?
- What is the relationship between AU-C 265B and the independence rules relating to nonattest or nonaudit services?
- Would a client's lack of segregation of duties automatically cause the auditor to communicate a material weakness?
- Should a control deficiency that allows fraud to occur always be considered a material weakness?

The discussion beginning in the following paragraph addresses the first two questions and provides the authors' views. Segregation of duties problems, material misstatements identified during the course of the audit, and evaluating the severity of a control deficiency that allows fraud to occur are all discussed later in this section.

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 governments 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 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, 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 and (b) they are independent under AICPA and, if applicable, *Government Auditing Standards* independence requirements. Before the auditor concludes he or she can prepare financial statements for an audit client because the independence requirements can be met, the auditor also should consider the cumulative effect on threats to independence of performing multiple nonattest services.

The auditor's preparation of the financial statements and the related notes does not relieve the client of the responsibility for the financial statements and for the establishment of controls over the financial reporting process. However, management can outsource their responsibility. Revisions to the AICPA *Code of Professional Conduct* deleted from the ethics rules 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 (a) agrees to accept responsibility for such controls and (b) performs all the requirements of ET 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.

Lack of Segregation of Duties. 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 265B. As such, an auditor should evaluate the severity of the deficiency by considering the probability of occurrence of a misstatement and the size of the potential misstatement.

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 entity for many years, management frequently leaves blank, signed checks with the bookkeeper to be used "in case of emergency." Management does not perform any oversight functions but, instead, believes that the auditors are a substitute for lack of oversight. Therefore, the auditors perform quarterly interim procedures, including a review of bank reconciliations 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. Because there is at least a reasonable possibility that the bookkeeper could use one of the blank checks to make an unauthorized withdrawal of the government's funds, and that withdrawal could be material, the auditor concludes that the deficiency is a material weakness. (This example assumes there are no compensating controls such as management performing 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. The auditor's identification of a material misstatement of the financial statements in circumstances that indicate 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 significant deficiency or a material weakness. Exhibit 3-3 illustrates a situation in which the auditor's evaluation of the severity of a control deficiency that allowed a material misstatement in the financial statements resulted in its classification as a material weakness.

Exhibit 3-3

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 financial statements, the auditor concluded this deficiency would be considered a material weakness.

If the auditor identifies a misstatement that is less than material, the authors believe 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 265B requires the auditor to communicate such deficiencies to the appropriate parties.

Occurrence of Fraud. When the 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 involved deficiencies in a client's controls over its parts inventory that 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 of the fraud was not material, the auditor is required to evaluate the potential for further 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 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, the authors believe that an auditor generally would consider the control deficiency a significant deficiency. In any event, AU-C 240B, *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 265B.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 265B.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 260B, *The Auditor's Communication With Those Charged With Governance* (at AU-C 260B.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 265B.11 states that 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 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. AU-C 265B.A17 requires the auditor 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 had been remediated by year end. (If management is preparing a written response to the auditor's communication, it may wish to include a statement that the significant deficiency had been remediated by year end.)

Significant Deficiencies and Material Weaknesses Previously Communicated (but Not Remediated). Although management and those charged with governance may already 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 265B 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 yet been taken. AU-C 265B.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, the authors believe 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 Communication

AU-C 265B.12 states that the auditor should provide a written communication of the significant deficiencies and material weaknesses identified during the audit. According to AU-C 265B.14, this communication should include the following:

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 905B, *Alert that Restricts 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 265B.A18 states that the auditor may consider the following factors:

- *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.
- *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 in a simple environment.
- *The Nature of Significant Deficiencies and Material Weaknesses the Auditor Has Identified.*

- *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.
- *Legal or Regulatory Requirements Regarding the Communication of Specific Types of Deficiencies in Internal Control.*

Timing of the Communications

AU-C 265B.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 230B, *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 265B.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 230B.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 265B.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 265B.

Reporting When There Are No Significant Deficiencies

AU-C 265B.16 precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because of 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 265B.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 judgment, 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 265B.A34 does not preclude the auditor from issuing such a communication. (As previously discussed, however, AU-C 265B.16 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 265B.15 states that the written communication should include the matters required by AU-C 265B.14(a), (c), and (d).

Reporting When There Are Material Weaknesses but No Significant Deficiencies

If there are material weaknesses but no significant deficiencies, the auditor needs to take care in wording the report to avoid stating or implying that there are no significant deficiencies. In other words, the prohibition described above ("Reporting When There Are No Significant Deficiencies") still has to be followed. The report should conform with the requirements described earlier in the paragraphs on Contents of Communication, but there should be no definition of, or other reference to, significant deficiencies.

Reports Required by *Government Auditing Standards*

Yellow Book requirements for internal control communications are outside the scope of this course, but *PPC's Guide to Audits of Local Governments* discusses Yellow Book requirements for reporting internal control deficiencies. The *Guide* also provides examples of reports on internal control over financial reporting and on compliance and other matters that should be issued in an audit performed in accordance with *Government Auditing Standards*.

Reports Required in a Single Audit

Internal control communications appropriate for reporting responsibilities in a Single Audit are also discussed further in *PPC's Guide to Audits of Local Governments*.

Management's Response

Management may choose to or be required (by a regulator, lender, etc.) to prepare a written response to the auditor's communication. The response might include, for example, a description of 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 written 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 to the communication:

> City X, State Y'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.

Illustrative Yellow Book reports and Single Audit reports provided by the AICPA use a slightly different wording for the disclaimer of opinion on management's response to the auditor's internal control (and noncompliance) findings.

Other Internal Control Deficiencies

During the audit, the auditor may identify other deficiencies that are not significant deficiencies or material weaknesses but that may still warrant management's attention. AU-C 265B.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 are less severe control deficiencies (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 report on internal control or other communication of significant deficiencies and material weaknesses 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 265B.12 clarifies that a written communication is not required. However, if the auditor decides to communicate the information orally, the standards state 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.

COMMUNICATING WITH THOSE CHARGED WITH GOVERNANCE

Introduction and Authoritative Literature

In addition to the communication of internal control matters, the communication of fraud and violations of laws and regulations, and the communication about the entity's ability to continue as a going concern, the auditor should communicate certain other matters to those charged with governance. AU-C 260B, *The Auditor's Communication With Those Charged With Governance*, establishes requirements and provides guidance on the auditor's communication with the individuals responsible for an entity's governance. The communication requirements apply to all nonpublic entities, including governmental entities, regardless of their governance structure or size. However, AU-C 260B does not establish requirements for communication with management unless they are also charged with a governance role.

Identifying Those Charged with Governance

AU-C 260B.06 defines *those charged with governance* as the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel, such as executive members of a governance board. A corporate trustee is one example of an organization that could serve as "those charged with governance."

The *Code of Professional Conduct* (ET 0.400.48) explains that *those charged with governance* are the persons or organizations responsible for oversight of the entity's strategic direction and the obligations related to its accountability. This includes oversight of the financial reporting process. Management personnel, such as executive members of a governance board, may be among those charged with governance.

The governance structures of governmental units can vary, and, as a result, determining who is charged with key governance functions may be difficult. SLG, Paragraph 15.43, indicates that in these circumstances the auditor evaluates the organizational structure that the governmental unit uses for directing and controlling operations. The auditor's evaluation includes how the governmental unit delegates authority and establishes accountability for its management personnel. If appropriate persons cannot be clearly identified, then the auditor and the party who engaged the auditor may need to discuss and agree on the relevant persons within the governance structure to whom the auditor will communicate.

Most governmental units will have either an audit committee or group of individuals formally designated with oversight of financial reporting. State and local laws frequently specify such oversight responsibility for individual governmental units. The auditor should evaluate whether communication with a subgroup of those charged with governance adequately meets the responsibility to communicate with those charged with governance. When making this determination, the auditor may want to consider matters such as:

- The various responsibilities of the governing body and the subgroup.
- The nature of matters to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup is authorized to act in relation to the information communicated.
- Whether the subgroup can provide the auditor with further information and explanations.
- Whether the auditor knows of any potential conflicts between the subgroup and other members of the governing body.
- Whether the auditor decides there is also a need to communicate the information, in full or summary form, to the governing body. (Regardless of whether the auditor communicates with a subgroup, the auditor retains the right to communicate with the governing body.)

Effective Two-way Communication

One of the objectives stated in AU-C 260B.05 is to promote effective two-way communication between the auditor and those charged with governance. AU-C 260B.20 requires the auditor to evaluate the adequacy of such two-way communication. Effective two-way communication assists both the auditor and those charged with governance to understand matters related to the audit and develop a constructive working relationship. It also enables those charged with governance to fulfill their responsibility to oversee the financial reporting process. Further, the auditor may be able to obtain important information from those charged with governance that is relevant to understanding the client and its environment, identifying sources of audit evidence, and obtaining information about specific events and transactions.

Matters to Be Communicated

AU-C 260B.10–.14 discusses the following matters that auditors are required to communicate to those charged with governance:

a. *Auditor Responsibility.* The auditor's responsibilities under generally accepted auditing standards.

b. *Planned Scope and Timing of the Audit.* An overview of the planned scope and timing of the audit.

c. *Significant Findings from the Audit.* The auditor's views about matters or issues that the auditor considers to be significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

d. *Uncorrected Misstatements.* Information regarding uncorrected misstatements should also be communicated.

The Auditor's Responsibilities under GAAS

AU-C 260B.10 requires communication of the auditor's responsibilities under GAAS, including that (a) the auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly in accordance with GAAP and (b) the audit does not relieve management or those charged with governance of their responsibilities. (These responsibilities may be communicated in the engagement letter if the engagement letter is provided to those charged with governance.)

The auditor is also permitted to communicate that—

- The auditor is responsible for performing the audit in accordance with GAAS and that the audit is designed to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement.
- The audit includes consideration of internal control as a basis for designing audit procedures but not for expressing an opinion on internal control.

- The auditor is responsible for communicating significant audit-related matters that the auditor judges to be relevant to those charged with governance in overseeing the financial reporting process. The auditor is not required to design procedures for the purpose of identifying other matters to communicate.
- The auditor is responsible for communicating specific matters required by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement.
- The auditor identified matters that, in his or her judgment, may reasonably be thought to bear on independence and to which the auditor gave significant consideration in reaching a conclusion that independence was not impaired.

The types of independence matters that the auditor might determine it is appropriate to communicate to those charged with governance include business or family relationships, nonaudit services provided or expected to be provided, or indirect financial interests. The auditor might wish to explain these threats and the safeguards that reduce them to an acceptable level.

Planned Scope and Timing of the Audit

AU-C 260B.11 requires the auditor to communicate the planned scope and timing of the audit, including significant risks the auditor has identified. However, this communication can not be so detailed as to compromise the effectiveness of the audit. For example, communicating the nature and timing of detailed audit procedures may make those procedures predictable and compromise their effectiveness. Planning matters the auditor might want to communicate include—

- How the auditor plans to address the significant risks of material misstatement due to error or fraud.
- The auditor's approach to internal control, including whether the auditor will express an opinion on the effectiveness of internal control over financial reporting.
- A discussion of materiality as it relates to planning and performing the audit—focusing on factors considered, not on specific amounts or thresholds.
- The extent to which the auditor will use the work of internal auditors, if applicable, and how the internal and external auditors can best work together. AU-C 610B, *Using the Work of Internal Auditors*, requires the auditor to also communicate with those charged with governance and obtain written acknowledgment about how the auditor plans to use internal audit to provide direct assistance. AU-C 610B also requires management and those charged with governance to acknowledge that internal audits providing direct assistance will be allowed to follow the auditor's instructions and that the entity will not interfere in the work the internal auditor performs for he auditor.

Significant Findings from the Audit

AU-C 260B.12 requires the auditor to communicate significant matters, findings, or issues from the audit, including—

- The auditor's views about qualitative aspects of the governmental unit's significant accounting practices, including accounting policies, estimates, and financial statement disclosures. When applicable, the auditor should also—
  - Explain why a significant accounting practice that is acceptable under U.S. GAAP is not considered appropriate in the particular circumstances of the entity.
  - Determine that those charged with governance are informed about the process used by management in developing particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.
- Significant difficulties encountered during the audit. (This might include significant delays in receiving required information, unnecessarily brief time to complete the audit, extensive and unexpected effort required to obtain audit evidence, unavailability of evidence, restrictions imposed on the auditors by

management. In some circumstances, significant difficulties encountered during the audit may constitute a scope limitation.)

- Significant unusual transactions.
- Disagreements with management about matters that could individually or in the aggregate be significant to the financial statements or auditor's report, regardless of whether the disagreements were satisfactorily resolved. However, disagreements with management in this context do not include differences of opinion based on incomplete facts or preliminary information that are subsequently resolved.
- Circumstances affecting the form and content of the auditor's report.
- Difficult or contentious matters that involve consultation outside of the engagement team and are significant and relevant to the responsibilities of those charged with governance for oversight of the financial reporting process.
- Other findings or issues that the auditor judges to be significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

Uncorrected Misstatements. AU-C 260B.13 requires the auditor to communicate uncorrected misstatements (other than those considered to be trivial), including the effect they might have on the auditor's opinions to those charged with governance. The auditor should discuss material uncorrected misstatements individually and request that they be corrected. (If there are a large number of individually immaterial uncorrected misstatements, the auditor may summarize them and communicate the number and overall monetary effect.) The auditor needs to discuss the implications of not correcting known and likely misstatements and explain that uncorrected misstatements or underlying matters could cause financial statements of future periods to be misstated even if immaterial to the financial statements under audit. The auditor should also communicate the effect of prior period uncorrected misstatements on classes of transactions, account balances or disclosures, and on the financial statements of the applicable opinion unit taken as a whole.

When Some of Those Charged with Governance Are Not Involved in Management. Unless everyone charged with governance is also involved in managing the entity (which is unlikely in a government), the auditor is also required, under AU-C 260B.14, to communicate—

- Material corrected misstatements that were brought to the attention of management as a result of audit procedures.
- Written representations the auditor is requesting from management.
- The auditor's views about significant accounting or auditing matters that were the subject of management consultation with other accountants, when the auditor is aware that such consultation took place.
- Significant issues arising from the audit that were discussed with management or were the subject of correspondence with management.

When the Auditor Is Restricted from Communicating with Those Charged with Governance. The auditor may be legally restricted from communicating certain matters. For example, laws or regulations may specifically prohibit a communication or other action that might prejudice an outside investigation of violations or noncompliance. The auditor may want to consult with the firm's legal counsel in this situation.

The Communication Process

To help establish the basis of the communication process, the auditor should communicate the form, timing, and expected general content of communications with those charged with governance. Communicating such information clearly helps lay the groundwork for effective two-way communication between the auditor and those charged with governance.

It may also benefit effective two-way communication if the auditor—

- Discusses the purpose of communications.
- Identifies the person(s) on the audit team and among those charged with governance who will generally communicate about matters.
- Conveys his or her expectation that communications will be two-way with those charged with governance communicating about matters they consider relevant to the audit.
- Explains the process for taking action and reporting back on matters between the audit team and those charged with governance.

Timing of Communications. AU-C 260B.19 indicates that the auditor should communicate with those charged with governance on a timely basis. The appropriate timing of communications will vary with the circumstances of the engagement. In deciding the timing, the auditor generally considers the significance and nature of the matter and the action expected to be taken by those charged with governance. For example, the auditor may want to communicate—

- Planning matters early in the engagement or, for an initial engagement, as part of the terms of the engagement.
- Significant difficulties encountered during the audit as soon as practicable if they may lead to a modified opinion or if those charged with governance are expected to help the auditor overcome the difficulties.
- Matters related to auditor independence in connection with accepting the engagement when the auditor has given significant consideration to circumstances or relationships that create a threat to independence.

Forms of Communication

AU-C 260B.16 requires written communication of significant findings or issues when, in the auditor's professional judgment, oral communication would not be adequate. Significant findings or issues that were communicated with those charged with governance and subsequently resolved do not need to be included. Other communications may be oral or written and may be formal or informal, including discussions.

When the communication is written, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management and is not intended and should not be used by anyone other than these specified parties.

When a significant matter is discussed with an individual member of those charged with governance, the auditor may want to consider summarizing it in later communications so that all persons charged with governance are fully informed.

Evaluating Adequacy of the Communication

AU-C 260B.20 requires the auditor to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate. The evaluation may be based on the auditor's observations about whether those charged with governance—

- Took appropriate and timely actions in response to matters communicated by the auditor.
- Openly communicated with the auditor.
- Were willing and able to meet with the auditor without management present.
- Have the ability to fully comprehend matters communicated by the auditor.
- Experienced difficulty in establishing a mutual understanding with the auditor about the form, timing, and expected general content of communications.

- Are aware of how matters discussed with the auditor affect their governance responsibilities (applies only if the individual is also a member of management).

If, in the auditor's judgment, the communication with those charged with governance was not adequate, it may indicate that the auditor has not obtained sufficient appropriate evidence to form an opinion on the financial statements. The auditor should evaluate the effect on the auditor's risk assessment and ability to obtain sufficient appropriate audit evidence and take appropriate action. If the situation cannot be resolved, the auditor may take other actions, such as—

- Modifying the opinion to reflect a scope limitation.
- Obtaining legal advice about the consequences of different actions.
- Communicating with third parties.
- Withdrawing from the engagement.

Documentation of Communications

AU-C 260B.21 requires the auditor to document matters that have been communicated orally (including when and with whom they were communicated). This documentation may include a copy of minutes prepared by the entity. When matters have been communicated in writing, the auditor should retain a copy of the communication. The engagement letter may be used to communicate planning matters, including the auditor's responsibilities under GAAS and the planned scope and timing of the audit, as long as the letter is provided to those charged with governance.

Other Requirements to Communicate with Those Charged with Governance

In addition to the requirements to communicate with those charged with governance found in AU-C 260B, as discussed in this section, requirements for the auditor to communicate with those charged with governance are also located in certain other AU-C sections. These additional communications are generally required only under the specific circumstance, and thus, are not included in every communication. These other possible required communications with those charged with governance are found in the following AU-C sections:

- AU-C 210B, *Terms of Engagement*.
- AU-C 240B, *Consideration of Fraud in a Financial Statement Audit*.
- AU-C 250B, *Consideration of Laws and Regulations in an Audit of Financial Statements*.
- AU-C 265B, *Communicating Internal Control Related Matters Identified in an Audit*.
- AU-C 550, *Related Parties*.
- AU-C 560B, *Subsequent Events and Subsequently Discovered Facts*.
- AU-C 570B, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- AU-C 600B, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
- AU-C 610B, *Using the Work of Internal Auditors*.
- AU-C 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, (added by SAS No. 134).
- AU-C 705B, *Modifications to the Opinion in the Independent Auditor's Report*.
- AU-C 706B, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*.
- AU-C 720B, *Other Information in Documents Containing Audited Financial Statements*.

- AU-C 730B, *Required Supplementary Information*.
- AU-C 930B, *Interim Financial Information*.
- AU-C 935B, *Compliance Audits*.

The AICPA has recently issued a series of auditing standards affecting many of the pronouncements in the preceding list.

Communication with Those Charged with Governance in a Compliance Audit

AU-C 935B, *Compliance Audits*, clarifies communications with those charged with governance in an audit conducted in accordance with GAAS, *Government Auditing Standards*, and a governmental audit requirement for the auditor to issue an opinion on compliance. It requires auditors to communicate the following:

- The auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement (i.e., the Uniform Guidance).
- An overview of the planned scope and timing of the compliance audit.
- Significant findings from the compliance audit.

AU-C 935B requires the auditor to provide written communication of significant deficiencies and material weaknesses in internal control over compliance to those charged with governance and management.

SELF-STUDY QUIZ

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

18. Danny, a CPA, is engaged to perform a governmental audit. His government client includes required supplementary information (RSI) that is required by the GASB. What authoritative guidance should Danny consult to determine what procedures he needs to perform to report on this RSI?

    a. GASB Cod. Sec. 2200.105.

    b. AU-C 730B.

    c. GASBS No. 44.

    d. The Yellow Book.

19. Diana, an auditor, is using the PPC process for evaluating the severity of deficiencies in internal control. What is Diana's second step in this process?

    a. Consider whether deficiencies that are not material weaknesses merit attention as a significant deficiency.

    b. Consider whether the deficiency should be communicated to management in accordance with AU-C 265B.12(b).

    c. Determine whether an identified deficiency is a material weakness.

    d. Determine whether deficiencies are material weaknesses or significant deficiencies when combined with others.

20. Stevie, a CPA, audits a local government. During an audit, she identifies a material weakness in internal control. Which of the following should Stevie include in her written communication regarding internal control?

    a. Information that is sufficient to explain the communication's context.

    b. A paragraph allowing third parties to use the communication.

    c. The definition of a deficiency in internal control.

    d. A quantification of the potential effects of the material weakness.

21. Which of the following items is required by AU-C 260B.10 when communicating the auditor's responsibilities under GAAS to those charged with governance?

    a. That the auditor will form and express an opinion on whether the financial statements are presented fairly in accordance with GAAP.

    b. That the auditor will design audit procedures for identifying matters that need to be reported to those charged with governance.

    c. That audit procedures performed will allow the auditor to express an opinion on internal control.

    d. That the audit is designed to obtain absolute assurance about whether the financial statements are free of material misstatement.

SELF-STUDY ANSWERS

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

18. Danny, a CPA, is engaged to perform a governmental audit. His government client includes required supplementary information (RSI) that is required by the GASB. What authoritative guidance should Danny consult to determine what procedures he needs to perform to report on this RSI? **(Page 412)**

    a. GASB Cod. Sec. 2200.105. [This answer is incorrect. This section of the GASB Code prescribes the basic components of a comprehensive annual financial report (CAFR). It does not include information about the procedures Danny needs to perform in this scenario.]

    b. **AU-C 730B. [This answer is correct. The AICPA Auditing Standards Board establishes standards for auditors reporting on RSI, including RSI required by the GASB. AU-C 730B, *Required Supplementary Information*, states that the auditor should apply certain procedures to RSI, such as inquiring of management about the methods of preparing the information.]**

    c. GASBS No. 44. [This answer is incorrect. GASBS No. 44, *Economic Condition Reporting: The Statistical Section—an amendment of NCGA Statement 1*, applies when a government chooses to present a statistical section with its basic financial statements (generally as part of a CAFR). This piece of authoritative literature does not provide the procedures Danny needs in this scenario.]

    d. The Yellow Book. [This answer is incorrect. The guidance Danny needs to determine what procedures to perform is not provided in the Yellow Book. He will need to consult a different piece of authoritative literature.]

19. Diana, an auditor, is using the PPC process for evaluating the severity of deficiencies in internal control. What is Diana's second step in this process? **(Page 419)**

    a. **Consider whether deficiencies that are not material weaknesses merit attention as a significant deficiency. [This answer is correct. When using the PPC process to evaluate the severity of an identified control deficiency under AU-C 265B, the second step is to consider, for an identified deficiency not considered a material weakness, whether it is important enough to merit attention by management and those charged with governance as a significant deficiency.]**

    b. Consider whether the deficiency should be communicated to management in accordance with AU-C 265B.12(b). [This answer is incorrect. This communication requirement would be performed last under the PPC process, as this requirement relates to deficiencies in internal control that the auditor has concluded do not need to be communicated as significant deficiencies or material weaknesses.]

    c. Determine whether an identified deficiency is a material weakness. [This answer is incorrect. When evaluating the severity of an identified control deficiency under AU-C 265B, this course suggests that auditors generally begin by considering whether an identified deficiency is considered a material weakness. Thus, this step is performed first when using the PPC process for evaluating the severity of deficiencies in internal control under AU-C 265B.]

    d. Determine whether deficiencies are material weaknesses or significant deficiencies when combined with others. [This answer is incorrect. The third step in the PPC process is to 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.]

20. Stevie, a CPA, audits a local government. During an audit, she identifies a material weakness in internal control. Which of the following should Stevie include in her written communication regarding internal control? **(Page 424)**

    a. **Information that is sufficient to explain the communication's context. [This answer is correct. According to AU-C 265B.14, the written communication should include sufficient information to allow those charged with governance and management to understand the context of the communication. Among other things, Stevie should include elements to explain that the purpose of the audit was for the auditor to express an opinion on the financial statements, and that the auditor is not expressing an opinion on the effectiveness of internal control.]**

    b. A paragraph allowing third parties to use the communication. [This answer is incorrect. According to AU-C 265B.14, the written communication should include 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 905B. Therefore, Stevie should not indicate that other third parties are allowed to use the communication.]

    c. The definition of a deficiency in internal control. [This answer is incorrect. According to AU-C 265B.14, the written communication should include the definition of a material weakness and, when relevant, of a significant deficiency. In this scenario, Stevie is dealing with a material weakness, so that is the definition she needs to include. The definition of deficiency in internal control would be too broad.]

    d. A quantification of the potential effects of the material weakness. [This answer is incorrect. According to AU-C 265B.14, the written communication should include a description of each significant deficiency and material weakness identified along with an explanation of their potential effects. However, 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, it would be better for Stevie to describe the potential effects in terms of (1) the control objectives that might not be achieved; (2) the types of errors the control was designed to prevent, or detect and correct; or (3) the risk(s) of misstatement that the control was designed to address.]

21. Which of the following items is required by AU-C 260B.10 when communicating the auditor's responsibilities under GAAS to those charged with governance? **(Page 428)**

    a. **That the auditor will form and express an opinion on whether the financial statements are presented fairly in accordance with GAAP. [This answer is correct. AU-C 260B.10 requires communication of the auditor's responsibilities under GAAS, including that (1) the auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly in accordance with GAAP and (2) the audit does not relieve management or those charged with governance of their responsibilities.]**

    b. That the auditor will design audit procedures for identifying matters that need to be reported to those charged with governance. [This answer is incorrect. The auditor is permitted, but not required, to communicate that the auditor is responsible for communicating significant audit-related matters that the auditor judges to be relevant to those charged with governance in overseeing the financial reporting process. The auditor is not required to design procedures for identifying other matters to communicate.]

    c. That audit procedures performed will allow the auditor to express an opinion on internal control. [This answer is incorrect. The auditor is permitted, but not required, to communicate that the audit includes consideration of internal control as a basis for designing audit procedures but not for expressing an opinion on internal control.]

    d. That the audit is designed to obtain absolute assurance about whether the financial statements are free of material misstatement. [This answer is incorrect. The auditor is permitted, but not required, to communicate that he or she is responsible for performing the audit in accordance with GAAS and that the audit is designed to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement.]

COMMUNICATING VIOLATIONS OF LAWS AND REGULATIONS AND FRAUD

Introduction and Authoritative Literature

AU-C 250B, *Consideration of Laws and Regulations in an Audit of Financial Statements*, imposes detection and communication responsibilities for violations of laws and regulations, including when and with whom they were communicated, that have a *direct and material effect* on the determination of financial statement amounts. AU-C 250B imposes lesser responsibilities for detection of violations of laws or regulations having *material but indirect* effects on the determination of financial statement amounts (primarily inquiry and inspection of any relevant correspondence) and establishes communication responsibilities for those violations. This section discusses the auditor's responsibilities when evidence indicates that a violation of laws or regulations or fraud may have occurred.

When a Violation of Laws and Regulations or Fraud May Have Occurred

When the auditor is confronted with information indicating potential noncompliance with laws and regulations (such as noncompliance cited in regulatory examination reports or the payment of fines and penalties) or a circumstance that indicates the possibility of fraud (such as a discrepancy between the accounting records and other audit evidence, including transactions with no supporting documentation, no apparent authorization, or that have not been recorded), the auditor should consider how and why it might have occurred and investigate further. If the investigation indicates there may have been fraud or a violation of laws or regulations, the auditor should do the following:

a. Obtain an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements and auditor's report (including the need for adjustments and for disclosure of a violation of laws or regulations and any related contingencies, or the need for a report modification if necessary financial statement adjustments or disclosures are not made or because of a scope limitation).

b. Consider the implications for other aspects of the audit; e.g., risk assessment and reliance on management's representations.

c. Discuss the matter and the need for any further investigation with an appropriate level of management at least one level above those involved.

d. If appropriate, consult with the client's legal counsel (or suggest that the client consult with legal counsel) on any questions of law and on the course of action the client should take.

e. Document a description of the identified or suspected fraud or violation of laws and regulations and the results of any conversations with management, those charged with governance, and others, if applicable.

In the rare event that officials of the governmental unit are not willing to follow sound legal advice about fraud or violations of laws or regulations, the auditor should consider seeking the recommendation of legal counsel about possible courses of action, including possible withdrawal from the engagement. The auditor would of course carefully document all communications related to the matter and its disposition.

Under AU-C 250B and AU-C 240B, the auditor ordinarily is not responsible for disclosing fraud or violations of laws and regulations to parties other than senior management and those charged with governance; however, both specifically recognize the auditor's duty to disclose such matters to a funding agency or other specified agency in accordance with governmental audit requirements; e.g., in a Single Audit or a financial audit made in accordance with the GAO's *Government Auditing Standards*. Also, state laws may require communication of certain fraud or violations of laws or regulations. Some states provide criminal penalties for those who fail to report a felony to the proper authorities. Others require auditors to maintain confidentiality. The authors recommend that auditors seek legal advice in those situations.

Communications about Violations of Laws and Regulations or Possible Fraud

AU-C 250B.21 requires that the auditor ensure that the audit committee or others charged with governance are adequately informed about any violations of laws or regulations, unless clearly inconsequential, that come to the auditor's attention. If the auditor determines there is evidence fraud may exist (even if the matter is inconsequential), the auditor is required to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. AU-C 240B.A70 indicates that auditors *may consider it appropriate* to communicate with those charged with governance about misappropriations committed by lower-level employees that do not result in a material misstatement. Auditors also normally reach an understanding with those charged with governance regarding communication about those misappropriations committed by lower-level employees. In the absence of such an agreement, the authors believe the auditor needs to report all instances of fraud to both the appropriate level of management and to those charged with governance. The authors recommend that communications about possible fraud be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

In some cases, the auditor may have a duty to disclose violations of laws or regulations or fraud to parties outside of the governmental unit. Examples of those situations include—

- To comply with legal or regulatory requirements.
- To a successor auditor making inquiries in accordance with AU-C 210B, *Terms of Engagement*.
- When responding to a subpoena.
- To a government funding agency or other specified agency when complying with requirements for audits of recipients of governmental financial assistance.

Before disclosing instances of fraud to parties outside the governmental unit, the authors recommend the auditor consult with legal counsel due to the nature of the auditor's ethical and legal obligations.

If any identified fraud risks have internal control implications, the auditor should determine whether they represent deficiencies related to the entity's internal control that should be reported in accordance with AU-C 265B. The absence of or deficiencies in processes and controls designed to mitigate or otherwise prevent, deter, and detect fraud may also be matters that require communication. Auditors also may wish to communicate identified fraud risks that are not otherwise required to be communicated to those charged with governance.

Government Auditing Standards Requirements for Communicating Fraud, Noncompliance, and Abuse

Government Auditing Standards establish certain other requirements for communicating with those charged with governance or other responsible officials. Communications related to subsequent discovery of facts on previously-issued financial statements are discussed later in this lesson.

The Yellow Book, Paragraph 6.41, requires auditors to communicate relevant information about:

- Noncompliance with provisions of laws, regulations, contracts, or grant agreements that has a material effect on the financial statements or other financial data significant to the audit objectives; or
- Fraud that is material, either quantitatively or qualitatively, to the financial statements or other financial data significant to the audit objectives.

Under both GAAS and the Yellow Book, auditors are required to determine whether those charged with governance are adequately informed about fraud and noncompliance with laws and regulations that have a more than inconsequential effect on the financial statements. The Yellow Book expands this to include noncompliance with provisions of contracts and grant agreements. The Yellow Book requires the auditor to provide written communication about findings of noncompliance "that are less than material but warrant the attention of those charged with governance." Whether and how to communicate findings that are inconsequential or do not warrant the attention of those charged with governance is a matter of professional judgment. The authors recommend that these be communicated in a management letter.

Under certain circumstances, auditors are required to report to those charged with governance when management fails to respond appropriately to the auditor's findings of known or likely fraud, noncompliance, or abuse. As discussed earlier in this section, the auditor may also be required to report the matters directly to outside parties. The Yellow Book indicates auditors should report directly to those charged with governance:

- Management's failure to report findings of fraud or noncompliance to external parties when required to do so by laws or regulations.
- Management's failure to respond in a timely and appropriate manner when findings of fraud or noncompliance are likely to have a material effect on the financial statements and involve funds received from another government agency.

Reporting Directly to outside Parties. As discussed in the previous paragraph, in certain circumstances, the auditor is required to communicate to those charged with governance management's failure to respond appropriately to findings of fraud or noncompliance. If, after the auditor's communication with those charged with governance, the entity's response is still inadequate, the auditor should communicate directly with outside parties as follows:

- The auditor should report relevant information directly to external parties if (a) the auditor has communicated to those charged with governance that management has not met legal or regulatory requirements to report fraud, noncompliance, or abuse to specific external parties and (b) the entity does not report the findings as soon as practicable after this communication.
- The auditor should report relevant information directly to the funding agency if (a) the auditor has communicated to those charged with governance that management failed to take timely, appropriate actions to respond to findings of fraud or noncompliance that involves funding received directly or indirectly from a government agency and is likely to be material to the subject matter (financial statements) and (b) the entity does not take appropriate steps as soon as practicable after this communication.

In both of these situations, the auditor should obtain sufficient appropriate audit evidence (for example, by confirmation with outside parties) to corroborate management's assertion that it has reported such findings in accordance with laws, regulations, and funding agreements. If unable to do so, the auditor should report the findings. The above reporting requirements are in addition to any other legal requirements to report such findings directly to outside parties and are applicable even if the auditor has resigned or been dismissed from the audit.

Paragraph 6.13 of the Yellow Book states that the auditor may also be required by laws, regulations, or policies to report indications of fraud or noncompliance with provisions of laws, regulations, contracts, and grant agreements before performing additional audit procedures. Additionally, Paragraph 6.12 of the Yellow Book requires the auditor to inquire of management of the audited entity whether any investigations or legal proceedings have been initiated or are in process with respect to the period under audit. Auditors should evaluate the effect of initiated or in-process investigations or legal proceedings on the current audit. Paragraph 6.14 indicates that it may be necessary to withdraw from the engagement or to defer work in order to avoid interfering with investigations.

THE USE OF MANAGEMENT LETTERS

Management letters (or another form of written communication) are used to communicate matters that are not required to be included in the auditor's communication to those charged with governance of significant deficiencies and material weaknesses identified during the audit. Paragraph 6.44 of the Yellow Book states that (a) identified or suspected noncompliance with provisions of laws, regulations, contracts, or grant agreements comes to the auditor's attention during the course of an audit that has an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance, or (b) when the auditor has obtained evidence of identified or suspected instances of fraud that have an effect on the financial statements or other financial data significant to the audit objectives that are less than material but warrant the attention of those charged with governance, the auditor should communicate in writing to audited entity officials. The GAS/SA Audit Guide, Paragraph 4.76, explains that this written communication may be done in a management letter. The Yellow Book leaves to the auditor's judgment whether and how to communicate fraud or noncompliance with provisions of laws, regulations, contracts, and grant agreements that does not warrant the attention of those charged with governance. The authors recommend that these also be communicated in a management letter. Also, neither GAAS nor the Yellow Book precludes communicating other items in a management letter, such as recommendations for improving internal controls or operational efficiencies. If less serious control deficiencies or other inconsequential audit findings are communicated orally, the auditor should document the communication. The GAS/SA Audit Guide, at Paragraph 4.77, recommends that auditors use language in the management letter that enables readers to distinguish between matters that are required to be reported from those that are not required. Auditors should include in their audit documentation evidence of all communications to officials of the audited entity about deficiencies in internal control found during the audit.

The Uniform Guidance has no specific requirement for auditors to provide a management letter. However, because Single Audits must be performed in accordance with *Government Auditing Standards*, there is an indirect requirement for auditors to provide a written communication of noncompliance with provisions of contracts or grant agreements or abuse that has an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance. Auditors are precluded from using management letters to communicate any findings that the Uniform Guidance requires to be reported in the schedule of findings and questioned costs.

Although the authors believe management points should be written, the letters need not be as formal as the other reports. Management letters should not be "boilerplates," because they may deal with such a wide range of topics. Rather, they should be responsive to the individual client situation and the auditors' actual observations. Management points might be communicated by any combination of descriptive commentary, tabular arrangements, graphs, lists, and illustrations. However, the authors recommend that all management letters include certain introductory information designed to prevent client misunderstanding about the nature of the comments or that the letter represents assurance about the adequacy of controls.

The authors believe the relevant aspects of a management letter include—

a. The letter should be dated the same date as the auditor's report on the financial statements. However, the auditor may also choose to communicate significant matters during the course of the audit when timely communication is important.

b. Management letters should be addressed to those charged with governance and senior management.

c. A statement that the letter is a result of the audit of the financial statements.

d. A statement that during the audit certain immaterial matters were noted and that these matters are summarized in this letter. Some auditors prefer to include the comments in a separate memorandum.

e. A reference is made to any separate report on internal control or separate communication of internal control deficiencies.

f. The letter may be used for the *Government Auditing Standards* required written communication of noncompliance with provisions of contract or grant agreements, or abuse, that has an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance.

g. Some auditors include a statement that the management points will be reviewed the following year. Such a statement can make an impression about their seriousness to the auditors and may prompt the client to take their implementation more seriously.

h. Auditors may offer to discuss the points with management, to perform any necessary follow-up studies, or to assist in implementing the recommendations.

i. Auditors should draft the letter with the understanding that a copy of the letter may be submitted to government agencies. Since the information may also be available to the press and general public under the Freedom of Information Act, the letter should not include names, social security numbers, other personal identification, or other potentially sensitive matters.

j. Due to materiality and other considerations, comments may be significant deficiencies to one entity and not another.

k. A statement that the findings included in the letter are only a result of audit procedures performed based on risk assessment procedures and that not all deficiencies or weaknesses in controls may have been identified.

Additional Guidance on Management Letters

Comprehensive guidance and tools to help auditors effectively communicate other deficiencies in internal control or operations that are often referred to as management letter comments are available in *PPC's Guide to Management Letter Comments: Operations and Controls*. The *Guide* includes more than 1,000 illustrative comments that may help improve the organization's operations, procedures, and controls. The *Guide* can be ordered at **tax.thomsonreuters.com** or by calling customer service at (800) 431-9025.

PREPARING AN ENGAGEMENT SUMMARY MEMORANDUM (ESM)

AU-C 230B.08 requires that the auditor document the significant findings or issues that arose during the audit, including related conclusions and significant professional judgments. AU-C 230B.A13 suggests that the preparation of a summary, or completion, memorandum that includes a description of significant findings or issues and how the audit addressed them can be helpful in meeting this documentation requirement. The authors refer to it as an engagement summary memorandum (ESM).

The purpose of the ESM is to summarize information that is already included in the audit workpapers and to document the auditors' conclusions based on the audit as a whole. Some firms do not prepare ESMs for their audit engagements (especially smaller engagements) because the information included in the ESM can be found elsewhere in the workpapers. Benefits of preparing an ESM include the following:

- The ESM summarizes the results of the engagement for the supervisory reviewer. As a result, the supervisory reviewer can focus on reviewing the workpapers for the areas with significant issues that have been identified in the ESM.
- The ESM provides a means for the auditor to document the reasoning behind significant judgments made during the audit and to document changes made to the audit plan and audit strategy during the engagement (after the planning documents are prepared).
- If the firm has a policy for engagements to be subject to engagement quality control review, the independent reviewer typically may only need to review the audited financial statements, auditor's report, ESM, lawyers' letters, management representation letter, and other summary documentation.
- The ESM for the previous audit is a useful tool when planning the current-year audit because it may identify risk areas or other matters to address when planning the current-year engagement.

Generally, the ESM is prepared by the engagement team member who has an overall understanding of the significant issues encountered during the audit. Normally, this would be the audit senior or in-charge auditor.

Content of the ESM

An ESM generally includes the following information:

- A brief description of the governmental unit and its operations.
- A summary of the governmental unit's operating results.
- A brief recap of the results of the auditor's risk assessments and identification of any significant risks.
- Discussion of significant accounting and auditing issues, including matters that involve significant professional judgment.
- An indication of the review performed by the engagement partner.

- A summary of uncorrected misstatements.
- Summary of significant deficiencies and material weaknesses.
- Subsequent events.
- Overall opinions.
- Documentation of the report release date and the documentation completion date.
- Subsequent revisions to workpapers.
- Other matters, such as identification of engagement team members, summary of the closing meeting held with the client, issues for inclusion in a management letter, known changes or efficiency considerations for consideration when planning the subsequent year's engagement, and client service opportunities.

Background Information. The background information included in an ESM provides a brief description of the governmental unit's activities, programs, services, and significant operating policies. In addition, information about historical financial results may be provided. The background information section is usually very brief—the information can be covered in a few short paragraphs. (Some firms do not include this section.)

Recap of Risk Assessments. This section of the ESM provides an overview of the risk assessments made by the auditor during the audit. Generally, the discussion summarizes the nature of the risks identified and the nature of procedures performed to respond to the risk. This section of the ESM also identifies risks that the auditor determined to be significant risks (i.e., risks that, in the auditor's judgment, warrant special audit consideration) and the nature of the auditor's response to the significant risks. This section may also discuss low-risk areas and the reasons for the auditor's conclusion that risk is low. In addition, this section provides an opportunity for the auditor to document changes made to the audit approach after the planning documents were prepared. Such changes may result from the auditor identifying additional risks during the audit. The auditor documents the additional risks identified and the auditor's response in this section of the ESM.

Summary of Financial Results. This section of the ESM normally provides an overview of the entity's current-year (audited) financial results compared with the prior period. The financial results are normally presented at a high level. Explanations of significant variances are included based on information obtained during the audit.

Significant Accounting and Auditing Issues. AU-C 230B.08 requires auditors to document significant audit findings or issues, conclusions reached, and significant professional judgments made in reaching conclusions. Auditors are also required to record any discussions of such matters with parties outside of the audit firm or the engagement team. This section includes narrative discussions of the auditor's reasoning process behind significant decisions made during the audit and documents the auditor's compliance with AU-C 230B, *Audit Documentation*. Matters generally covered in this section include the following:

- Audit areas that involve significant judgment such as valuation allowances for receivables, loss provisions for impairment of assets, significant accruals for other loss contingencies (such as environmental liabilities), and conclusions reached about other significant contingencies (such as litigation). This could also include audit areas in which the client implemented significant new accounting standards.
- Significant transactions that are complex or unusual in nature (such as accounting changes or changes in estimates, and significant unusual transactions). If the auditor had to consult with a technical expert (whether inside or outside the firm) to determine the proper accounting treatment of a significant transaction, a summary of the consultation could also be included.
- Difficult judgments about materiality of uncorrected misstatements in transaction classes, account balances, or disclosures, especially completeness of disclosures for which materiality depends entirely on qualitative aspects. For example, the auditor documents the reasoning behind not making certain disclosures that the client determines are not material.
- Issues that result in audit reports being modified.

- Audit areas that included unusual or more extensive audit procedures than normal (for example, areas that warranted additional procedures as a result of the auditor's assessment of the risk of material misstatement due to fraud, areas where the auditor noted control deficiencies, and areas that involved the use of a specialist).

- Significant related-party transactions that triggered accounting or audit issues requiring consultation, especially those that are also significant unusual transactions.

- Legal issues identified in the request for legal representation letter and conclusions reached about other significant contingencies (such as litigation).

This list is not intended to be all-inclusive. The auditor uses his or her judgment in deciding what significant matters to include in the ESM. The authors recommend including a summary of any relevant issues in the ESM that are subject to supervisory review, particularly issues that could have a significant effect on the auditor's opinion on the financial statements.

Review Performed by the Engagement Partner. AU-C 230B.09 requires documentation of who reviewed specific audit documentation and the *date* of the review. Some auditors, especially those performing the partner level review, may prefer documenting the evidence of their review in the ESM, indicating the workpaper sections reviewed and the date(s) of their review instead of signing and dating (on paper or electronically) individual workpapers.

Summary of Uncorrected Misstatements. Preparation of a summary of uncorrected misstatements (or audit differences) was discussed in Lesson 2. The summary may be included as an attachment to the ESM. However, some auditors prefer to summarize the passed adjustments for presentation in the ESM. Generally, only those differences in reported amounts that have an effect on the change in fund balance/net position are presented. If there are uncorrected misstatements in disclosures, those would also be addressed, including attaching a separate memorandum if deemed necessary. However, if the auditor has proposed significant reclassification adjustments, those are also addressed in the ESM.

Summary of Significant Deficiencies and Material Weaknesses. This section of the ESM provides an overview of the significant deficiencies and material weaknesses identified during the audit. These items are generally presented at a summary level—that is, they are listed and identified as either significant deficiencies or material weaknesses. The auditor may also document here the date of the written communication to management and those charged with governance.

Subsequent Events. The ESM documents the procedures performed and any conclusions reached regarding subsequent events.

Opinion Statement. The ESM generally includes opinions on the following matters:

- The adequacy of the audit scope.

- Fairness of presentation of the audited financial statements in accordance with GAAP or a special purpose framework.

- The appropriateness of modifications to the auditor's report, if necessary.

An example of the opinion statement that could be included in the ESM is as follows:

> It is my opinion that the scope of our audit was adequate and that the financial statements of City of X, State Y, for the year ended September 30, 20X2, are presented fairly in accordance with generally accepted accounting principles.

Report Release Date and the Documentation Completion Date. AU-C 230B.15 requires the auditor to document the report release date in the workpapers. The *report release date* is the date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For audits of most entities, this will be the date that the auditor delivers the report to the client. The auditor may document that date in the ESM.

AU-C 230B.06 refers to the date that workpapers should be assembled for retention as the *documentation completion date*. The final assembly and completion of the audit file should occur within 60 days of the report release date. After that date, the auditor should not delete or discard any documentation prior to the required five-year retention period. While AU-C 230B does not specifically require the auditor to document the documentation completion date, as a practical matter documentation of that date ensures compliance with the requirement to complete final assembly of the workpapers within 60 days of the report release date and establishes a starting date for the required retention period.

Subsequent Revisions to Workpapers. The next section discusses revisions to workpapers after the documentation completion date. The ESM can be used to document revisions to the workpapers made after the documentation completion date and provide evidence that the change was reviewed.

Signing the ESM. Generally, the ESM is signed and dated by the preparer and each reviewer (for example, the audit manager, partner, and management quality control reviewer).

Specialized Considerations for Governmental Units. Background information for a governmental unit would also include a description of the governmental unit's population, form of government, budgetary process, and size of budget. Significant accounting and auditing issues include methods used to develop the estimates included in the presentation of capital assets, pollution remediation obligations, pension and OPEB liabilities, etc. Additionally, the ESM includes the opinion on the appropriateness of any Yellow Book or Single Audit reports.

SUBSEQUENT DISCOVERY OF MATTERS AFTER THE REPORT DATE

Introduction and Authoritative Literature

Subsequent to the date of the auditor's report, the auditor may become aware of facts that existed on that date that might have caused him or her to believe information supplied by the governmental unit was incorrect, incomplete, or otherwise unsatisfactory had he or she then been aware of them. In such circumstances, the auditor should consider the guidance in AU-C 560B, *Subsequent Events and Subsequently Discovered Facts*, in determining an appropriate course of action. Subsequent to the date of the auditor's report, the auditor may also conclude that certain necessary auditing procedures were omitted from the audit, but there is no indication that the financial statements are materially misstated. AU-C 585B, *Consideration of Omitted Procedures After the Report Release Date*, provides guidance in that situation.

Subsequent Discovery of Facts Existing at the Date of the Report

AU-C 560B contains separate requirements for situations where facts are discovered before the report release date and those situations where facts are discovered after the report release date. However, when facts are discovered after the report is issued, the auditor is generally required to do the following:

a. If the information that the auditor becomes aware of is of such a nature and from such a source that he would have investigated it had it come to his attention during the engagement, he should investigate it as soon after it comes to his attention as is practical.

b. If, after investigation, the auditor determines that (1) his report or the financial statements would have been affected if the information had been known to him at the date of his report and (2) he believes there are persons currently relying on, or likely to rely on, the financial statements who would attach importance to the information, he should advise the governmental unit to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are relying on the financial statements and the related auditor's report.

c. The method of disclosure by the governmental unit might, depending upon the circumstances, take one of the following forms:

   (1) Issuance of revised financial statements and auditor's report.

   (2) Disclosure of the revision in subsequent financial statements instead of reissuing the earlier statements.

(3) Notification to the users of the statements that they should not be relied upon and that revised statements will be issued upon completion of an investigation.

d. If the governmental unit refuses to make the requested disclosures, the auditor should notify appropriate parties and take appropriate steps to prevent future reliance upon his report. Possible courses of action are discussed in AU-C 560B.A23–.A26.

According to AU-C 560B.A18, the guidance is applicable even if the auditor has withdrawn or been discharged.

PPC's Guide to Auditor's Reports provides reporting guidance when the decision is made to issue revised financial statements and auditor's report.

Consideration of Omitted Procedures

According to AU-C 585B.06, when the auditor determines that certain necessary auditing procedures were omitted, the auditor should assess the importance of the omitted procedures on his ability to support the opinion expressed on the financial statements. Review of the workpapers, discussions with others assigned to the engagement, and reevaluation of the overall audit scope may be helpful in making the assessment. The results of subsequent audits also may be considered.

If the auditor concludes that he or she is unable to support the auditor's opinion on the previously issued financial statements, and there are persons currently relying on, or likely to rely on, the report, the auditor should promptly apply the omitted procedures or alternative procedures that would support the opinion. After applying the procedures, if the auditor becomes aware of facts existing at the date of the report that would have affected the report had the auditor then been aware of them, the auditor should follow the guidance of AU-C 560B for subsequently discovered facts.

If the auditor is unable to apply the omitted or alternative procedures, he may decide to consult with an attorney to determine an appropriate course of action. If performing the omitted procedures necessitates changing workpapers that have previously been finalized, auditors should document the information noted below.

Because of the potential legal implications of a determination that necessary audit procedures have been omitted or that the audit report or audited financial statements were materially inaccurate, auditors may decide to consult their attorneys any time the circumstances described in this section are encountered.

Documentation Requirements

AU-C 230B.14 establishes documentation requirements for revisions that are made to the workpapers after the date of the auditor's report. When the auditor determines that the guidance in AU-C 560B or AU-C 585B apply, the general documentation requirements of AU-C 230B should be followed when evidencing the auditor's procedures. When documenting the necessary revisions to the workpapers as a result of these procedures, including any new conclusions that were reached, the following information should be recorded:

- When the change was made and reviewed.
- Who made and reviewed the change.
- Reasons for the change.
- The procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report.

The auditor cannot, however, delete or discard any audit documentation after the documentation completion date and through the retention date.

SELF-STUDY QUIZ

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

22. Joan, a CPA, is auditing a local government. She discovers information that indicates a potential violation of the law could have occurred. What should Joan do next?

    a. Withdraw from the engagement immediately.

    b. Investigate the potential violation further.

    c. Report the potential violation to the authorities.

    d. Discuss the matter with her client's management.

23. Which of the following would generally be included in the ESM?

    a. Detailed background information about the government.

    b. A projection of future financial results.

    c. Identification of key people in the client's management.

    d. The auditor's opinion on the financial statements.

24. Gladys, a CPA, is the audit senior on an audit of a governmental entity. Subsequent to the date of the auditor's report, Gladys discovers subsequent events that require changes be made to the workpapers. All the following tasks should be completed, **except**:

    a. Documenting when the changes were made and reviewed.

    b. Documenting who made and reviewed the changes.

    c. Documenting the procedures that were performed.

    d. Discarding the superseded audit documentation.

SELF-STUDY ANSWERS

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

22. Joan, a CPA, is auditing a local government. She discovers information that indicates a potential violation of the law could have occurred. What should Joan do next? **(Page 438)**

    a. Withdraw from the engagement immediately. [This answer is incorrect. In the rare event that officials of the governmental unit are not willing to follow sound legal advice about fraud or violations of laws or regulations, the auditor should consider seeking the recommendation of legal counsel about possible courses of action, including possible withdrawal from the engagement. However, withdrawal would not be Joan's first reaction to a potential violation.]

    b. **Investigate the potential violation further. [This answer is correct. When the auditor is confronted with information indicating potential noncompliance with laws and regulations or a circumstance that indicates the possibility of fraud, the auditor should consider how and why it might have occurred and investigate further. Therefore, Joan should perform this investigation before taking any other action regarding the potential violation.]**

    c. Report the potential violation to the authorities. [This answer is incorrect. Under AU-C 250B and AU-C 240B, the auditor ordinarily is not responsible for disclosing fraud or violations of laws and regulations to parties other than senior management and those charged with governance; however, both specifically recognize the auditor's duty to disclose such matters to a funding agency or other specified agency in accordance with governmental audit requirements. Also, state laws may require communication of certain fraud or violations of laws or regulations. However, even if it was determined that Joan needed to make this communication, it would not be her first action upon discovering a potential violation.]

    d. Discuss the matter with her client's management. [This answer is incorrect. If it is likely that the violation occurred, Joan would do several things, including obtaining an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements and auditor's report, and discussing the matter and the need for any further investigation with an appropriate level of management. However, Joan must do something else first, before she gets to this point.]

23. Which of the following would generally be included in the ESM? **(Page 444)**

    a. Detailed background information about the government. [This answer is incorrect. ESMs would typically include a brief description of the governmental unit and its operations. The background information section is usually very brief—the information can be covered in a few short paragraphs.]

    b. A projection of future financial results. [This answer is incorrect. The ESM normally provides an overview of the entity's current-year (audited) financial results compared with the prior period. The financial results are normally presented at a high level.]

    c. Identification of key people in the client's management. [This answer is incorrect. Other matters that can be included in an ESM are identification of the engagement team members.]

    d. **The auditor's opinion on the financial statements. [This answer is correct. The ESM generally includes opinions on the following matters: (1) the adequacy of the audit scope; (2) fairness of presentation of the audited financial statements in conformity with GAAP or a special purpose framework; and (3) the appropriateness of modifications to the auditor's report, if necessary.]**

24. Gladys, a CPA, is the audit senior on an audit of a governmental entity. Subsequent to the date of the auditor's report, Gladys discovers subsequent events that require changes be made to the workpapers. All the following tasks should be completed, **except**: **(Page 446)**

    a. Documenting when the changes were made and reviewed. [This answer is incorrect. Information regarding when the change was made and reviewed should be recorded, according to the documentation guidance in AU-C 230B.]

    b. Documenting who made and reviewed the changes. [This answer is incorrect. According to the documentation guidance in AU-C 230B, information about who made and reviewed the change should be recorded.]

    c. Documenting the procedures that were performed. [This answer is incorrect. The guidance provided about documentation in AU-C 230B indicates that the procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report should be recorded.]

    d. **Discarding the superseded audit documentation. [This answer is correct. According to AU-C 230B, the auditor *cannot* delete or discard any audit documentation after the documentation completion date and through the retention date.]**

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 3—Concluding the Audit (ALGTG213)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. 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 those 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 the PDF and can be printed if needed.

2. **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 $109 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.

3. **PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. 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
     ALGTG213 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.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 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 $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (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.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **April 30, 2022**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 3—Concluding the Audit (ALGTG213)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. An existing condition that could create an obligation in the future that would need to be disclosed in the financial statements is defined as which of the following?

   a. Going concern consideration.

   b. Contingency.

   c. Subsequent event.

   d. Commitment.

2. Don, a CPA, is engaged to audit the government of Fairview. How should Don approach the audit procedures to determine if there are commitments and contingencies?

   a. Don should perform procedures related to litigation, claims, and assessments, as they could be the cause of significant contingencies.

   b. Making inquiries of management and other officials are the only audit procedures that will help Don discover commitments and contingencies.

   c. Don will not need to perform specific audit procedures related to commitments and contingencies because they are very easy to find.

   d. Don should only perform procedures on recorded commitments and contingencies.

3. During the course of his audit, Gregg discovers that the government of Allman retained a law firm to represent them in a lawsuit. What is Gregg's primary means of corroborating the information his client furnished about this lawsuit?

   a. Perform audit procedures, such as reading meeting minutes.

   b. Communicate directly with the law firm.

   c. Use a management letter.

   d. Use an engagement summary memorandum.

4. Under which of the following circumstances will a lawyer not furnish information to an auditor or confirm the completeness of information provided by management?

   a. Items in the legal letter exceed performance materiality.

   b. The pending litigation list is prepared by the client.

   c. There is an unasserted claim or assessment.

   d. The likelihood of an unfavorable outcome is remote.

5. Which of the following governments needs to adjust its financial statements for a subsequent event?

   a. Government A has a loss from an uncollectible account due to a bankruptcy that was the result of a year of deteriorating financial conditions.

   b. Government B has a loss from an uncollectible account due to a bankruptcy that was the result of a fire.

   c. Government C has a loss due to changes in the quoted market price of several securities.

   d. Government D loses money due to start-up costs for the creation of a new component unit.

6. Carlos is engaged to audit a small, local government. The government should have disclosed information about all the following as related-party transactions, **except**:

   a. Negotiating a compensation arrangement with administrative officials.

   b. Selling land from a city park to the mayor.

   c. Leasing a government-owned building to a member of the city council.

   d. Buying office supplies from a company owned by a member of the board of education.

7. An auditor will perform which of the following procedures for related parties at the end of the governmental audit?

   a. Vouching, confirming, and recomputing related party transactions to obtain assurance that there are no misstatements.

   b. Considering whether information discovered during applied audit procedures indicates related party transactions that should be disclosed.

   c. Obtaining representations from senior administrative officials about whether they engaged in related party transactions with the government.

   d. Identifying obvious or known related parties and transactions to be kept in mind while performing other audit procedures.

8. Which of the following circumstances indicates substantial doubt that a government can continue to be a going concern?

   a. Low estimated liability for actual claims in uninsured areas.

   b. Realized large investment losses.

   c. An increasing tax base because of a rising population.

   d. Recurring operating losses that are subsidized.

9. According to AU-C 570B.16, which of the following is **not** a procedure an auditor should perform to obtain sufficient, appropriate audit evidence about whether conditions and events identified and considered in aggregate raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time?

   a. Examine information that is available since the date of management's evaluation.

   b. Correct management's lack of analysis to support its evaluation.

   c. Ask that management perform an evaluation if they have not yet done so.

   d. Evaluate the underlying data generated to prepare the budget or forecast.

10. Which of the following examples from AU-C 540B.A47 best describes accounting estimates that can have high estimation uncertainty?

    a. Similar estimates from the prior period varied substantially from the outcome.

    b. Low dependency on judgment.

    c. Recognized measurement techniques used in calculations.

    d. A generalized, prevalent model with observable inputs is used for fair value accounting estimates.

11. Which of the following statements best describes how audit adjustments and uncorrected misstatements affect written representations from management?

    a. Specific guidance should be applied by the auditor when there are no uncorrected misstatements.

    b. Only misstatements brought to the auditor's attention by management should be mentioned in the representation letter.

    c. Unless clearly trivial, management should be requested to correct accumulated misstatements.

    d. Management must only acknowledge that uncorrected misstatements are immaterial individually, not in aggregate.

12. Gary is auditing a governmental entity. He plans the audit, performs audit procedures, and collects audit evidence. While performing substantive procedures, Gary discovers that misstatements occurred more frequently than he had expected. What is he required to do next, according to AU-C 330B.27?

    a. Disclaim an opinion on the financial statements or withdraw from the engagement.

    b. Note in his auditor's report that the misstatements are isolated occurrences.

    c. Reevaluate his assessment of the risk of material misstatement at the relevant assertion level.

    d. Request a management representation letter addressing the misstatements.

13. Which of the following is the determining factor in whether audit evidence is sufficient and appropriate?

    a. The auditor's professional judgment.

    b. Whether all the required procedures were performed.

    c. Quantitative and qualitative factors listed in AU-C 330B.

    d. The number of misstatements found.

14. What is the main purpose for performing analytical procedures near the end of the audit?

    a. Aid the auditor in assessing the validity of conclusions reached.

    b. Determine if the transactions lack substance.

    c. Evaluate the existence of fraud.

    d. Make an initial risk assessment.

15. Peter is an audit senior at the firm of Gabriel & Genesis. He is performing the detailed review of audit work on a recent governmental audit performed by the firm. Which of the following is one of the steps he will perform during his review of the workpapers?

    a. Ensure that, for each financial statement component in each opinion unit, amounts agree with the amounts in the working trial balance and have been traced back to the statement of cash flows.

    b. Ensure that, for each financial statement component in each opinion unit, all audit programs have either been completed or justification was provided as to why they were not completed.

    c. Ensure that, for the general section of the file and the workpapers as a whole, significant audit findings and issues were adequately addressed and documented.

    d. Ensure that, for the general section of the file and the workpapers as a whole, unusual matters were excluded from the management representation letter.

16. A supervisory review of the workpapers focuses more on which of the following?

    a. Summary and evaluation schedules and documentation of significant findings and issues.

    b. Summary and evaluation schedules and all supporting workpaper schedules.

    c. Supporting workpaper schedules and documentation of insignificant findings and issues.

    d. Adherence to professional standards and firm policies and practices.

17. Which of the following accounting firms has correctly dealt with an issue related to engagement quality control reviews (EQCRs)?

    a. Hall & Oates only performs EQCRs on engagements with medium or low levels of risk.

    b. Steely & Dan opts out of performing an EQCR on an engagement that meets the firm's EQCR criteria.

    c. Sammy & David opts to perform an EQCR on an engagement that does not meet the firm's EQCR criteria.

    d. Everly CPAs perform EQCRs on engagements chosen by random selection rather than developing EQCR criteria.

18. Misstatements, which include both differences in reported amounts and differences related to disclosures or presentation, are also often referred to as which of the following?

    a. Factual misstatements.

    b. Audit differences.

    c. Projected misstatements.

    d. Accounting estimates.

19. Simon is performing an audit of a local government. What are his responsibilities related to the communication of misstatements in this engagement?

    a. He should distinguish the categories of misstatements for management.

    b. He must communicate all misstatements to management, even those that are clearly trivial.

    c. He should determine if it is necessary to ask management to correct accumulated misstatements.

    d. He should make all corrections for accumulated misstatements himself.

20. When evaluating whether the financial statements as a whole are free of material misstatement, the auditor should base that decision on which of the following?

    a. Opinion units.

    b. Governmental entity as a whole.

    c. Each fund.

    d. Management representations.

21. Benny identifies a misstatement while auditing a local government. According to AU-C 240B.35, which of the following should he do first?

    a. Withdraw from the engagement.

    b. Reassess the risks of material misstatement due to fraud.

    c. Assume that it is an isolated occurrence.

    d. Evaluate whether it could indicate fraud.

22. According to AU-C 450B, which of the following best describes how government auditors should aggregate audit differences during the summary of difference process?

    a. It is necessary for the auditor to aggregate uncorrected misstatements at the opinion unit level.

    b. As long as the auditor considers individual misstatements, there is no need to consider their combined effect.

    c. Auditors must follow the specific guidance in the auditing standards on the appropriate approach to aggregate audit differences.

    d. Auditors should use a different audit difference aggregation approach each period.

23. The CPA firm of Houston & Wonder is engaged to audit a local government. While performing the audit, a complex technical issue arises. Under the clarified auditing standards, who is responsible for ensuring that consultation is taken on this issue, if necessary?

    a. Client management.

    b. Firm management.

    c. The engagement team as a whole.

    d. The audit engagement partner.

24. Mick is engaged to audit a local government. Management asks Mick to draft the government's financial statements for the audit. Can he perform this service for his client and still perform the governmental audit?

    a. Yes, Mick can draft and accept responsibility for the financial statements without performing other procedures.

    b. No, Mick cannot draft the statements because he will lose his independence in relation to the client.

    c. No, because allowing Mick to draft the statements would constitute a weakness in the client's internal control.

    d. Yes, but he can only do so if management retains and acknowledges responsibility for the financial statements.

25. Lynne has just completed an audit of a local government and drafted her auditor's report. What should she do next?

    a. Consider scope limitations, GAAP departures, and other matters.

    b. Discuss the report and the financial statements with officials of the government unit.

    c. Take responsibility for the government's financial statements.

    d. Perform various communication responsibilities, such as communicating internal control matters.

26. Which of the following types of deficiencies in internal control over financial reporting should an auditor communicate in writing to management and those charged with governance?

    a. Deficiencies in design and deficiencies in operations when the entity has other strong controls that achieve the same control objective.

    b. Significant deficiencies and material weaknesses.

    c. Weaknesses where there is a remote possibility that a material misstatement of the financial statements will not be prevented.

    d. Material weaknesses only.

27. In which of the following examples does the auditor correctly fulfill his responsibility for identifying deficiencies in internal control under AU-C 265B.08?

    a. Joe performs procedures specifically tailored to identify any deficiencies existing in internal control.

    b. Ray performs procedures specifically tailored to identify any significant deficiencies or material weaknesses existing in internal control.

    c. Jimmy determines whether any deficiencies in internal control were identified while performing normal audit procedures.

    d. Tom has no responsibilities for identifying deficiencies in internal control in a GAAS audit, so no procedures need to be performed nor any determinations made.

28. AU-C 265B deals with evaluating the magnitude of a potential misstatement. What is the most difficult part of applying AU-C 265B?

    a. Determining the maximum amount that an account balance or transaction total could be overstated.

    b. Determining the amount of the identified control deficiency.

    c. Determining what is material to the financial statements.

    d. Determining the prior-period volume of activity in the accounts exposed to the deficiency.

29. Olivia audits a local government. Over the course of the engagement, she discovers deficiencies in internal control, including some that she considers significant deficiencies and material weaknesses. What is Olivia required to communicate in writing to those charged with governance?

    a. The material weaknesses and the significant deficiencies identified during the audit.

    b. All deficiencies in internal control that were identified during the course of the audit.

    c. Deficiencies in internal control that are not considered material weaknesses or significant deficiencies but that merit attention.

    d. Only significant deficiencies that the auditor believes cannot be remediated by year end.

30. Olivia's report release date is April 30. By what date must she make the required communications about internal control deficiencies?

    a. April 29.

    b. April 30.

    c. May 31.

    d. June 29.

31. Ella has completed her audit of a governmental entity. She identified no material weaknesses in internal control during the audit. Those charged with governance request that Ella provide a written communication indicating that no material weaknesses were discovered. Can she provide this communication?

    a. Ella cannot provide the communication in writing, but she can communicate the information orally.

    b. Yes, Ella can issue the communication if she includes matters listed in AU-C 265B.14.

    c. No, Ella is precluded by AU-C 265B from issuing such a communication.

    d. Do not select this answer choice.

32. How should Carly, a CPA, proceed if she identifies other, less severe deficiencies in internal control?

    a. If the deficiencies were previously reported and not corrected, they must be communicated again.

    b. The communication must be restricted to management only.

    c. They should be communicated if they are unreported and merit attention.

    d. No communication related to any less severe deficiencies is necessary.

33. What is the correct term for the person(s) or organization(s) that have the responsibility to oversee the strategic direction of the entity and the obligations related to the accountability of the entity?

    a. Those charged with governance.

    b. Accounting department.

    c. Regulatory authorities.

    d. Senior management.

34. Paul is performing a compliance audit on a governmental entity. He is required to communicate all the following to those charged with governance in this type of audit, **except**:

    a. The planned scope and timing.

    b. The auditor's responsibilities under GAAS.

    c. Significant findings.

    d. Immaterial errors corrected by management.

35. Which of the following statements is correct regarding an aspect of communicating with those charged with governance?

    a. Auditors can be legally restricted from communicating certain matters.

    b. Communication of the planned scope and timing of the audit should be very detailed.

    c. All communications should be made at the same time.

    d. Oral communication is never permitted to those charged with governance.

36. When should an auditor take information about fraud or noncompliance with laws or regulations directly to an external party?

    a. Any time fraud exists it should be reported outside of the entity.

    b. Auditors are never allowed to report finding to external parties.

    c. When the entity's response is inadequate after communication with those charged with governance.

    d. Do not select this answer choice.

37. Which of the following is a best practice for writing a management letter?

    a. The letter should be addressed to senior management and those charged with governance.

    b. The auditor should draft the letter casually, as only the audit client will ever see the finished letter.

    c. Firms should create a boilerplate template to use for all such letters.

    d. The letter should be dated as of the beginning of the audit.

38. Which of the following is an advantage of creating an engagement summary memorandum (ESM)?

    a. It can create efficiencies for engagement quality control reviews and planning for the next year's audit.

    b. It will be prepared by the audit partner with input from client management.

    c. It summarizes the results of the engagement for those charged with governance.

    d. None of the information included in the ESM can be found elsewhere in the workpapers.

39. Which of the following auditors has correctly dealt with a requirement related to subsequent discovery of facts that existed at the date of the auditor's report?

    a. Jimi cuts off his audit as of the date of the auditor's report and does not perform any additional investigation.

    b. Billie realizes her report would have been affected and advises her client to disclose these facts and their impact to persons who rely on the report.

    c. Elmore writes a letter disclosing these subsequent facts and attaches it to the auditor's report as supplementary information.

    d. Bonnie takes no action after discovery because she withdrew from the engagement.

40. Penny Pinchers, a CPA firm, completed an audit of a governmental entity. The workpapers are finalized. However, after the date of the auditor's report, the audit senior discovers that certain necessary auditing procedures were omitted. What authoritative guidance will provide the firm with the requirements to remedy this situation?

    a. AU-C 230B.

    b. The Yellow Book.

    c. AU-C 560B.

    d. AU-C 585B.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Local Governments—Course 3—Concluding the Audit (ALGTG213)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State/ZIP: ______________

Firm Phone: ______________________________ Firm Fax No.: ______________

Firm Email: ______________________________

Signature: ______________________________

Credit Card Number: ______________________________ Expiration Date: ______________

Birth Month: ______________________________ Licensing State: ______________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this: ⊘ ⊗ ✓

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
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.	○	○	○	○

You may complete the exam online for $109 by logging onto our Online Grading Center at **cl.tr.com/ogs.** Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com.* Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $109; the price for answer sheets sent by regular mail is $119.

Expiration Date: April 30, 2022

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Audits of Local Governments—Course 3—Concluding the Audit (ALGTG213)

Your Name (optional): ____________________ Date: ____________________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this: ● not like this: ⦸ ⊗ ✓

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
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 this page. **Yes/No** ○ ○

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GLOSSARY

Accounting estimate: An approximation of an amount in the absence of a precise measurement that is used when preparing financial statements.

Clearly trivial misstatement: Misstatements that 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 those determined to be immaterial.

Contingency: An existing condition that creates 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 They arise from past transactions or events and include both contingent assets and contingent liabilities (though the primary accounting and auditing focus is on contingent liabilities).

Commitment: A contractual obligation for a future expenditure.

Deficiency in design: This type of deficiency in internal control exists when (1) a control necessary to meet the control objective is missing or (2) 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 internal control: This 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 operation: This type of deficiency in internal control 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.

Document completion date: The date by which the workpapers should be assembled for retention. This final assembly and completion of the audit file should occur within 60 days of the report release date.

Engagement quality control review (EQCR): 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.

Engagement summary memorandum (ESM): An ESM summarizes information that is already included in the audit workpapers and documents the auditor's conclusions based on the audit as a whole. Information in the ESM can be found elsewhere in the workpapers.

Error: Unintentional misstatements of amounts or disclosures in the financial statements.

Factual misstatement: A misstatement about which there is no doubt.

Final review analytical procedures: Procedures used to consider the adequacy of the procedures performed during the audit.

Flux analysis: 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.

Fraud: An intentional act by an individual (or individuals) through the use of deception, which results in misstatement to the financial statements. Such misstatements could result from fraudulent financial reporting or misappropriation of the assets.

Iron curtain method: A method used to aggregate audit differences, also called the "balance sheet method." It focuses on the impact of misstatements on the audited statement of net position and considers the effect on current-period income of amounts needed to correct the statement of net position.

Judgmental misstatement: A misstatement 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.

Management letter: These are used to communicate matters that are not required to be included in the auditor's communication to those charged with governance of significant deficiencies and material weaknesses identified during the audit (e.g., findings of fraud, abuse, or noncompliance that are inconsequential or do not warrant the attention of those charged with governance and recommendations for improving internal controls or operational efficiencies).

Material weakness: This 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.

Nonrecognized events: Events that provide evidence with respect to conditions that did not exist at the date of the statement of net position but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some, however, may need to be disclosed.

Other internal control deficiencies: Control deficiencies that the auditor wishes to communicate that are less severe than significant deficiencies or material weaknesses.

Preliminary analytical procedures: Risk assessment procedures performed to obtain an understanding of the entity and its environment for the purposes of assessing the risks of material misstatement and determining whether further audit procedures should be performed in response to risk assessment.

Projected misstatement: 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.

Recognized events: Events that provide additional evidence with respect to conditions that existed at the date of the statement of net position and affect estimates inherent in the process of preparing the financial statements. The financial statements should be adjusted, if necessary, for changes resulting from such events.

Report release date: The date the auditor grants the entity permission to use the auditor's report in connection with the financial statements. In many cases, it is the date the auditor delivers the report to the client.

Required supplementary information (RSI): Information GAAP requires governments to present along with, but not included in, the basic financial statements.

Rollover method: A method used to aggregate audit differences, also called the "income statement method." It considers the effect of all misstatements (current-period misstatements as well as the impact of prior-period waived adjustments) on current-period income.

Significant deficiency: This 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.

Subsequent events: Events or transactions that affect the financial statements and that occur subsequent to the statement of net position date, but before the financial statements are issued.

Sufficient appropriate audit evidence: Evidence that the audit documentation has been reviewed; the financial statements, including disclosures, have been prepared; and management has taken responsibility for the financial statements.

Those charged with governance: The persons or organizations with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. They may include management personnel.

INDEX

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