ALGT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Audits of Local Governments

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Interactive Self-study CPE

Companion to PPC's Guide to Audits of Local Government

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

INTRODUCTION

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. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **March 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS

COURSE 1

SUBSTANTIVE PROCEDURES AND TESTING INTERNAL CONTROLS (ALGTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers the basics of performing substantive procedures and testing internal control. Lesson 1 discusses various aspects of substantive procedures, such as when they are required, designing them, performing them at an interim date, and fraud risks. Lesson 2 covers in detail the tests of operating effectiveness of controls, including circumstance when tests of controls should be performed and circumstances when testing is unnecessary or inefficient.

PUBLICATION/REVISION DATE: March 2010

RECOMMENDED FOR: Users of *PPC's Guide to Audits of Local Governments*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Yellow Book CPE Credit: This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing 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 **March 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Substantive Procedures

Completion of this lesson will enable you to:

- Determine which substantive procedures are required in every governmental audit and explain how to choose the appropriate substantive and analytical procedures for your audit.
- Explain how tests of details and transactions are applied; how substantive analytical procedures are designed; and describe the likely cause of potential misstatements and fraud and the availability of reliable data.
- Explain how to use audit evidence from prior periods and how to respond to fraud risks using specific responses.

Lesson 2—Testing Internal Controls

Completion of this lesson will enable you to:

- Determine when tests of controls should be performed and identify efficiency opportunities in testing controls.

- Develop a control risk assessment.
- Select and apply appropriate substantive procedures.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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Lesson 1: Substantive Procedures

INTRODUCTION

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 an 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.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine which substantive procedures are required in every audit and explain how to choose the appropriate substantive and analytical procedures for your audit.
- Explain how tests of details and transactions are applied; how substantive analytical procedures are designed; and describe the likely cause of potential misstatements and fraud and the availability of reliable data.
- Explain how to use audit evidence from prior periods and how to respond to fraud risks using specific responses.

Governmental Units Specialized Considerations

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 should design audit procedures that can be applied to the multiple funds, thus avoiding repetition.

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.

Single Audit Considerations

The Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor performing a Single Audit to test compliance with laws and regulations that could have a direct and material effect on each major federal award program. In addition, SAS No.117 (AU 801), *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. Section 500(d)(4) of OMB Circular A-133 states that "compliance testing shall include tests of transactions and such other auditing procedures as are necessary to provide the auditor sufficient evidence 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.

Authoritative Literature

The authoritative pronouncements establishing requirements that most directly affect designing substantive procedures are as follows:

a. SAS No. 56 (AU 329), *Analytical Procedures*, explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.

b. SAS No. 99 (AU 316), *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.

c. SAS No. 103 (AU 339), *Audit Documentation*, requires the auditor to document the work performed, the audit evidence obtained and its source, and the conclusions reached. In addition, it establishes other documentation requirements that need to be considered when designing audit programs and substantive procedures.

d. SAS No. 106 (AU 326), *Audit Evidence*, describes audit procedures used to obtain audit evidence.

e. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, addresses audit procedures that are responsive to risks at the relevant assertion level.

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.

The Auditing Standards Board is completing its large-scale project to redraft and revise all existing U.S. auditing standards to improve clarity and to converge with the International Standards on Auditing (ISAs). The ASB anticipates that the redrafted and clarified SASs, except those that address current issues, will be effective for audits of financial statements no earlier than for periods beginning on or after December 15, 2010. Standards that address current issues could have earlier effective dates.

REQUIRED SUBSTANTIVE PROCEDURES

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 SAS No. 110 (AU 318.51), "regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure." The reasons for this requirement 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 to internal control, including management override, and even effective internal controls generally reduce but do not eliminate, the risk of material misstatement.

In other words, even if the auditor concludes that the risk of material misstatement is low for a particular assertion related to a material account balance, transaction class, or disclosure based on performing risk assessment procedures and tests of controls, some substantive procedures are still required.

Financial Statement Reporting System

SAS No. 110 (AU 318.52) requires that the auditor perform the following substantive procedures in every audit:

- Agree the financial statements, including the accompanying notes, to the underlying accounting records.
- 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 4.77, 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.

SAS No. 99 (AU 316) also requires certain substantive procedures in all audits to address the risk of management override of controls. These required procedures are as follows:

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud (AU 316.58–.62).
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud (AU 316.63–.65).
- Evaluating the business rationale for significant unusual transactions (AU 316.66).

Both SAS No. 110 and No. 99 require examining journal entries and other adjustments, but the requirement of SAS No. 99 is focused on identifying fraudulent journal entries. As discussed in paragraph 6.69 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*, the nature, timing, and extent of procedures required by SAS No. 99 are different from those required by SAS No. 110. SAS No. 110 focuses on journal entries made during the course of preparing the financial statements and SAS No. 99 requires the auditor to consider reviewing journal entries made throughout the year. This distinction is also emphasized in a nonauthoritative AICPA Technical Practice Aid, *Examining Journal Entries* (TIS 8200.16). Auditors should ensure that their audit procedures satisfy both requirements.

Significant Risks

Significant risks are risks that require special audit attention. 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 318.54)

Other Required Audit Procedures

There are also other SASs that impose presumptively mandatory requirements for substantive procedures for particular account balances. Examples include the following:

- Confirmation of accounts receivable. (SAS No. 67, AU 330)
- 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. (SAS No. 1, AU 331)

Documentation

SAS No. 110 (AU 318.77) requires the auditor to document the following items relating to substantive procedures:

- 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

Other documentation considerations relating to substantive procedures are discussed throughout this course.

SELECTING SUBSTANTIVE PROCEDURES

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. SAS No. 106 (AU 326.06) 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, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.

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. SAS No. 106 (AU 326.08) 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 application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

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 or faxes.

Authoritative literature views audit evidence as being obtained from a variety of sources, including the auditor's assessment of risk. SAS No. 106 (AU 326.02) defines audit evidence as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information." 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.

SAS No. 106, on audit evidence, notes that audit evidence includes the information contained in the accounting records underlying the financial statements and other information. SAS No. 106 (AU 314.90) observes that control activities relevant to the audit include "reconciliation of the general ledger to the detailed records" and state that "the auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts." Further, agreeing the financial statements to the underlying accounting records is now a required procedure in every audit. Thus, without adequate attention to the propriety and accuracy underlying accounting data, an opinion on the financial statements is not warranted.

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 should increase. SAS No. 110 (AU 318.12) states that "the higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. This may affect both the types of audit procedures to be performed and their combination."

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. SAS No. 110 (AU 318.07) states that "the nature of audit procedures is of most importance in responding to the assessed risks." SAS No. 110 (AU 318.19) explains that "increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk and reliable; therefore, the nature of the audit procedure is the most important consideration."

Selecting Appropriate Substantive Procedures

The selection of specific substantive procedures needed to respond to the risk assessment is a matter of auditor judgment. This involves consideration of all the 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 Analytical Procedures and Substantive Tests of Details

Substantive procedures include tests of details and substantive analytical procedures. Therefore, designing the nature of substantive procedures involves deciding between 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 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 substantive tests of details. That is, given two procedures of equal effectiveness, the auditor chooses the one that is most efficient. Therefore, 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.

Generally, the higher the assessed risk of material misstatement, the more effective analytical procedures need to be before they can be relied on instead of tests of details. Accordingly, auditors tend to 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 has highly effective analytical procedures, it may be possible to reduce the extent of detail testing needed even in areas where significant risks exist. The effectiveness of analytical procedures in reducing detection risk in comparison with the effectiveness of tests of details generally depends on the facts and circumstances. However, the following are some general observations:

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. Therefore, 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, balance sheet 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. Therefore, analytical procedures would not be as effective as tests of details when responding to risks such as 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. 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 in 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. 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 looking at 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.

SELF-STUDY QUIZ

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

1. The audit team is designing audit procedures to provide appropriate audit evidence for a separate opinion on each opinion unit. How should the procedures be designed when the team performs audit procedures based on the government's cash disbursements cycle?

   a. To conform to the specialized circumstances of the client and its operations.

   b. To facilitate adherence to the budget.

   c. To provide sufficient coverage to each opinion unit.

2. An essential quality of audit evidence is its reliability. Which of the following scenarios is an accurate example of reliability of audit evidence?

   a. Layla is conducting an audit of Western University. Layla thinks that evidence obtained from sources within the entity would be beneficial in determining the sufficiency and appropriateness of the audit evidence.

   b. Nathan is conducting an audit of Manny's Music Shack, Inc. Nathan would rather have a written record of his meeting with Manny than an oral depiction of the matters discussed as reliable audit evidence.

   c. Molly is conducting an audit of Cards by Carl, Inc. Molly uses faxes provided by Carl as reliable audit evidence.

3. Which of the following statements regarding analytical procedures is most accurate?

   a. Best practices indicate that auditors should apply analytical procedures for risks related to matters such as parties to transactions deficient in economic substance.

   b. Relationships among operating statement accounts generally are more predictable than relationships among balance sheet accounts.

   c. Tests of details for assertions regarding the completeness of liabilities, expenses, revenues, and assets generally are more effective than analytical procedures.

   d. Analytical procedures are more dependable if they are based on trustworthy data created within the accounting system.

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. The audit team is designing audit procedures to provide appropriate audit evidence for a separate opinion on each opinion unit. How should the procedures be designed when the team performs audit procedures based on the government's cash disbursements cycle? **(Page 3)**

   a. To conform to the specialized circumstances of the client and its operations. [This answer is incorrect. When the primary risk is cooking the books, the focus of analytical procedures generally is on the revenues and expenses that might be misstated. The particular analytical procedures must be designed to fit the specialized circumstances of the client and its operations. The above procedures are not designed to conform to the specialized circumstances of the client and its operations.]

   b. To facilitate adherence to the budget. [This answer is incorrect. When considering the government's budgetary process, it is important that the governmental accounting systems and financial reporting are designed to facilitate and demonstrate adherence to the budget. The above procedures are not designed to adhere to the government's budget.]

   c. To provide sufficient coverage to each opinion unit. [This answer is correct. Often, a government's internal control system for a transaction is the same regardless of where the balances and transactions are reported in the financial statements. When this is the case, the auditor's consideration of internal control for that transaction cycle would equally apply to all applicable opinion units.]

2. An essential quality of audit evidence is its reliability. Which of the following scenarios is an accurate example of reliability of audit evidence? **(Page 6)**

   a. Layla is conducting an audit of Tie-dye Tees, Inc. Layla thinks that evidence obtained from sources within the entity would be beneficial in determining the sufficiency and appropriateness of the audit evidence. [This answer is incorrect. According to SAS No. 106, Layla should audit evidence from knowledgeable independent sources outside the entity, not within the entity.]

   b. Nathan is conducting an audit of Manny's Music Shack, Inc. Nathan would rather have a written record of his meeting with Manny than an oral depiction of the matters discussed as reliable audit evidence. [This answer is correct. Manny's audit evidence is more reliable when it exists in documentary form. According to SAS No. 106, contemporaneous written records of a meeting are more reliable than a subsequent oral representation of matters discussed.]

   c. Molly is conducting an audit of Cards by Carl, Inc. Molly uses faxes provided by Carl as reliable audit evidence. [This answer is incorrect. Audit evidence provided by original documents is more reliable than audit evidence provided by faxes or photocopies per SAS No. 106, because faxes and photocopies can be altered.]

3. Which of the following statements regarding analytical procedures is most accurate? **(Page 8)**

   a. Best practices indicate that auditors should apply analytical procedures for risks related to matters such as parties to transactions deficient in economic substance. [This answer is incorrect. Best practices indicate that analytical procedures generally are 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.]

   b. Relationships among operating statement accounts generally are more predictable than relationships among balance sheet accounts. [This answer is correct. Best practices indicate that 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. Therefore, analytical procedures would not be as effective as tests of details when responding to risks such as recording false receivables.]

c. Tests of details for assertions regarding the completeness of liabilities, expenses, revenues, and assets generally are more effective than analytical procedures. [This answer is incorrect. Best practices indicate that analytical procedures are often equally or more effective than tests of details for assertions about the completeness of assets, liabilities, revenues, and expenses. For example, the analytical procedure of estimating property taxes by multiplying reliable data in 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 more dependable if they are based on trustworthy data created within the accounting system. [This answer is incorrect. Best practices indicate that 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).]

APPLYING 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 the processing of individual transactions by 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—specifically due to compliance testing 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 or encumbrances for goods and services.

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 balance sheet account balances. In contrast, in a small business engagement, the primary focus is usually on 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 balance sheet account balances and transaction classes. The primary examples are as follows:

- Capital assets and capital expenditures.

- Debt and debt service expenditures.

Generally, the balance sheet 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 balance sheet 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. The mere fact that a transaction or balance is being tested does not make the test 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 being concerned with the effectiveness of control policies and procedures for processing individual transactions. It is the objective of the test and not whether it is applied to a class of transactions or a balance that determines whether the test is a test of controls or a substantive procedure. Substantive procedures, including tests of details, are normally applied after the auditor has obtained an understanding of internal control, but substantive tests of details in the current period may contribute to the auditor's understanding in subsequent periods.

Required Documentation

For substantive tests of details involving inspection of documents or confirmation, SAS No. 103, *Audit Documentation*, requires documentation to include identifying characteristics of the items tested. Best practices indicate that 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. For example:

- For tests of significant items, documentation may describe the auditor's scope and the source of the items (for example, all disbursements greater than $5,000 from the January disbursements).

- For haphazard or random samples, documentation may identify items by their dates and specific invoice numbers, check numbers, customer account numbers, etc.

- For systematic samples, documentation may indicate the source, starting point, and sampling interval (for example, a selection of checks from the cash disbursements journal for the period 1/1/X2 to 12/31/X2, starting with check number 2150 and selecting every 100th check thereafter).

In some cases, more than one file of the same documents is maintained by different client departments. The auditor should document who maintains the file from which items were selected and where the file is maintained.

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 should 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 include trend analysis, ratio analysis, and predictive or reasonableness tests. 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 that would be expected to have a predictable relationship to each other, 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 analytical procedures are thought of as a coordinated family of procedures that include scanning and inquiry as well as computations and comparisons. Scanning accounting records to identify unusual 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. SAS No. 56 identifies 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 client's business and assist in assessing areas of specific risk of misstatement by identifying unexpected relationships among account balances or the absence of expected relationships.

- *Substantive Analytical Procedures.* Used to obtain audit evidence about potential misstatements.

- *Overall Review Analytical Procedures.* Used in the final review stage of the audit.

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. 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 lesson.

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 analytic 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 the auditor will have already assessed the risk of misstatement of the account balance, 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 SAS No. 110 (AU 318.57), 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 that is acceptable.

Exhibit 1-1 provides factors that affect the expected effectiveness of an analytical procedure.

Exhibit 1-1

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 balance sheet accounts.
- *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 to Which the Data to Which the Analytical Procedure Is Applied Are Related to One Another.*
- *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* (for example, if 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 may have gained 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 should 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 should consider using the *original* budget to determine variances from actual. The auditor should 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 should 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, is payroll expense driven by the number of employees? 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 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 adopts determines the degree to which approved programs will be funded. For example, budgets often specify that particular funds finance particular costs and establish the nature and amount of interfund activity. The budget allocates anticipated resources and, normally, expenditures exceeding budgeted amounts are legally prohibited. 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.

Best practices indicate that, in a governmental engagement, audit procedures should 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 may be more important than a mechanical comparison. The auditor should think about these relationships and bring to bear other knowledge about the governmental unit and government operations.

Identify Government Comparables. For years, there have been suggestions that auditors should make 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 should be 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 should 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 on the Internet. Other possible sources of information for comparisons include the following:

- *CAFR.* GASB Statement No. 34 recommends that governments publish a Comprehensive Annual Financial Report. 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. The GASB's website includes numerous actual CAFRs categorized by type of government. The CAFRs can be accessed at **www.gasb.org/repmodel**/.

- *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 should attempt to find a few (or even just one) governmental units 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 on the Internet.

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 should only be combined and distributed with the clients' permission and typically should be 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 should get 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 should consider whether the data in the operating department is independent of the accounting department. The auditor should also consider 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, operating data can be used to design analytical tests that provide persuasive evidential matter on the validity and completeness of service revenue and receivables. Total service revenue can be computed by multiplying quantity of service provided during the period by the average rate; e.g., 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; e.g., an engineering record of water pumped adjusted for estimated leakage, evaporation, and faulty meters.

For another 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. These operating personnel could assist the auditor in developing expectations of revenues and related expenses.

Discussions with operating personnel should at a minimum 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

Audit Area or Type of Account. 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 income-statement account balances, or income-statement and certain balance-sheet account balances are more predictable than relationships only among balance-sheet 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 are random and 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 should be effective for detecting either overstatement or understatement of recorded revenue. In contrast, tests of details usually focus 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 random and 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 lesson.

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 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 should exercise professional skepticism in evaluating the reliability of available data and seek more reliable data to achieve greater precision.

For a governmental unit, property tax revenue provides an excellent example of an area where analytical tests are very effective because relatively accurate predictive tests can be made. Property taxes should be relatively easy to estimate because the factors involved (that is, assessed valuation and tax rate) are usually known. Fluctuations from period to period should 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 degree of accuracy of the expectation developed by the auditor to the actual amount. 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 .5% to 1% of total revenue, and tolerable misstatement would be less than planning materiality. This means that an expectation developed of recorded total annual revenue would need to be within less than 1% 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 a primarily substantive analytical procedures approach 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 more efficiently and 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's Excel.

b. Regression analyses of relationships between results for two or more periods can be performed using the regression analysis feature found in recent versions of Excel.

Data Extraction Software (DES). DES can also be used to assist in performing analytical procedures. DES 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 DES. 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.

Since most clients maintain much of their financial information electronically, DES is becoming a more common and important tool. It can be especially important in situations where 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 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 management fraud or cooking the books. 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 where 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 business obtained during the audit. More detailed preliminary analytical procedures or substantive analytical procedures used during the audit can also be helpful in detecting whether the books have been cooked. SAS No. 99 (AU 316.69) 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 revenues 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 reflect on whether responses to inquiries about analytical relationships 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 very 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 cooking the books. 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 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 cooking the books, finding at least one comparable entity for analytical comparisons as recommended earlier in this lesson, 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 recorded amounts are useful in refining the assessment of the risk of misstatement from cooking the books. When the primary risk is cooking the books, 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 flow with recorded accrued amounts and comparisons of the total recorded amount with the portion that is dependent on a subjective estimate are generally useful.

Ratios that compare cash flow related to a recorded amount to the total amount are often simply a more 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 income-statement 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 stealing. 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 stealing or cooking the books, 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 should 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 stealing and cooking the books. 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 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 should 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 should result in plausible, persistent relationships. For example, if service revenues from a particular service are increasing but related expenses are decreasing, the auditor should question why and regard the client's response skeptically. For example, 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. The auditor should 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 should 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 books are cooked. In corroborating explanations, the auditor should be 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 should carefully evaluate 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 should increase the auditor's suspicions that the books are cooked.

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 may need 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. SAS No. 110 (AU 318.62) on substantive tests prior to the balance-sheet date states that these procedures 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 should 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 rollforward 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 should be supplemented by inquiries of department personnel about significant or unusual activity close to year end.

Generally, the lower the level of disaggregation, 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 should identify and evaluate significant accounting estimates made by management. An appendix to SAS No. 57, *Auditing Accounting Estimates*, includes the following examples of accounting estimates that are relevant to governmental units:

- Uncollectible receivables.
- Losses on purchase commitments.
- Valuation of securities.
- Useful lives and residual values of productive facilities of proprietary funds, and depreciation and amortization methods.
- Actuarial assumptions in pension or OPEB costs.
- Probability and amount of losses in litigation.

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 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. SAS No. 56 (AU 329.20) states only that the criteria for a significant difference should be consistent with the level of assurance desired from the analytical procedure. Evaluation of the significance of differences is discussed below. 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. Corroboration of the explanation of differences is discussed below. If a significant difference is not explained by corroborated information, the auditor should typically reconsider the effectiveness of the analytical procedure, perform additional procedures, or consider whether to treat the entire difference as a likely misstatement to be posted to the summary of audit differences. Considerations before posting differences to the summary of audit differences are discussed below.

Evaluation of the Significance of Differences. The quantification of the significance of the difference should be related to what is material to the financial statements by opinion unit and by financial statement line as well as in the aggregate, rather than being evaluated in terms of the percentage of the account balance.

The practical issue is how to draw the dividing line between the amount that will be considered significant and 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 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 simply to develop a workable rule of thumb for deciding whether further inquiry and investigation is necessary. If a difference is evaluated as not significant and no further inquiry is deemed necessary, the difference is not a misstatement and should not be accumulated and posted to a summary of audit differences.

Corroboration of the Explanation of the Difference. The auditor's expectation developed in performing substantive analytical procedures is an estimate or prediction of what should be 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 enough (for example, based on reliable enough data, a precise enough expectation, etc.), then the test should be refined (such as computed in more detail), or the degree of assurance from the analytical procedure should be reduced and additional procedures should be applied.

If the auditor evaluates the difference as significant and 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 should be accumulated and posted to the summary of audit differences. A difference should not be 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 should not be 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 should avoid the temptation of first asking those responsible for preparing financial statements to explain differences. The auditor should obtain an explanation from a knowledgeable person who is preferably unrelated to financial statement preparation and analyze the support for that explanation. Explanations about the reasons for differences might be obtained from accounting department personnel, but should be 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 audit. 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 should 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 should 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 should consider whether there is a pattern of differences. Individual differences and the results of other audit procedures should not be 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 should then consider the nature and cause of the misstatement and the most effective approach to quantifying the misstatement. The quantified misstatement should be proposed as an audit adjustment.

How to Document Substantive Analytical Procedures

Documentation of Principal Substantive Tests of a Significant Financial Statement Assertion. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, SAS No. 56 (AU 329.22) requires the auditor to document the following:

- 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).

An analytical procedure is the principal substantive test of a significant financial statement assertion when it provides the primary audit evidence. Exhibit 1-2 presents an example of documentation of a substantive analytical procedure that is the primary test of an account balance.

Exhibit 1-2

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), best practices indicate that the expectation is apparent and that no additional documentation of the expectation is required. 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 should 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 tolerable misstatement rule of thumb).

Documentation of Other Types of Analytical Procedures. When an auditor performs an analytical procedure that is *not* a principal substantive test of a significant financial statement assertion, professional standards do not specify the form or content of documentation other than to state that audit documentation should include identifying characteristics of any specific items tested. For example, assume that an auditor's principal substantive analytical test of the valuation/allocation assertion for interest expense is an analytical procedure that consists of analyzing recorded interest expense to isolate amounts recorded for the debt with the largest principal balances and comparing those amounts with the amount calculated by applying rates for the individual's debts to average principal balances outstanding. Assume further that the auditor believes the expectation underlying the analytical procedure has most of the required precision, and to provide additional assurance about the valuation/allocation assertion for interest expense, the auditor computes an overall effective interest rate and compares it with the prior-year overall effective interest rate, with the expectation that the two rates will not differ significantly. The auditor has therefore, used two analytical procedures as substantive tests of the valuation/allocation assertion for interest expense. However, the first analytical procedure provides most of the assurance and is therefore the primary substantive test of the assertion. In this case, the second test would not be a principal substantive test and would not be subject to the same documentation requirements as the first one. In those instances, the detail of documentation will vary with the circumstances, including the materiality of the recorded amount, the assessed risk of material misstatement, and the level of assurance desired from the analytical procedure.

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 analytical procedures includes comparing ratios of recorded amounts to expectations developed by the auditor?

   a. Reporting the analytical procedures.

   b. Establishing an expectation of what an account balance should be.

   c. Studying the cause of unexpected significant difference.

   d. Assessing the possibility of material misstatement.

5. Which of the following is an example of a substantive analytical procedure?

   a. Identifying risks of material misstatements due to fraud.

   b. Inspecting invoices in support of additions to capital assets.

   c. Substantiating the balance of the capital asset account by testing the transactions.

   d. Comparing an account balance with the prior-period balance.

6. Marilyn is conducting an audit of Lehman University. Which of the following should Marilyn use to increase her knowledge of the client's business?

   a. Substantive procedures.

   b. Preliminary analytical procedures.

   c. Comprehensive review of analytical procedures.

7. Which of these statements best describes substantive analytical procedures?

   a. They are part of the final review of the financial statements.

   b. They are focused on particular account balances.

   c. They are made up of a finite set of ratios and procedures.

   d. They are required in all audits of financial statements.

8. What is the first step an auditor should take when designing effective analytical procedures conformed for the client's specific situation?

   a. Inquiring of management what relationships and ratios management regards as useful when monitoring risks.

   b. Evaluating key factors that affect the prospective relationships and operations in preparing the budget.

   c. Utilizing industry statistics as a source of data for comparisons in performing analytical procedures.

   d. Communicating with personnel outside the financial management regarding when to design and perform analytical procedures.

9. When devising substantive analytical procedures, what information should auditors gain from talking with their clients' operating personnel?

   a. A feel for how the client's business really works and an understanding of the information management uses when running the business.

   b. A working knowledge of key factors affecting the client's account balances and the stability of plausible relationships.

   c. An enhanced understanding of significant transactions and events that affect the financial statements.

   d. A comparison of how a client's performance compares to that of their competitors.

10. Substantive analytical procedures are based on a projected recorded amount based on a likely relationship between that amount and financial or nonfinancial data. These procedures are favored if reliable data to develop expectations is readily available. Which of the following statements regarding the availability of reliable data is most accurate?

    a. Auditors are encouraged to use data from an independent operating department.

    b. Auditors are not encouraged to seek additional data if the available date is reliable.

11. During audit planning, Ashleigh suspects there is a risk that management has cooked the books. What specific procedures does Ashleigh recommend to address this risk?

    a. Compare actual cash flow with recorded accrued amounts.

    b. Analytical comparisons with a comparable entity.

    c. Use certain specific ratios developed by her firm that will catch fraud in any client's financial statements.

    d. Substantive analytical procedures that prove whether potential misstatements were caused by fraud.

12. Asia is conducting an audit of the City of Goliad. Asia has developed an expected recorded amount from reliable data and compared the expectation to the recorded amount, what is her next step?

    a. Determine if there is a significant difference between the actual and expected amounts.

    b. Request of management and accounting personnel responsible for identified estimates, an explanation of the methods and procedures used to make the estimates.

    c. Inquire of management what relationships, ratios, and internal or external data management finds particularly useful, particularly in identifying and monitoring risks.

    d. Overall review analytical procedures.

13. During the course of her audit, Asia discovers a significant difference between her expectation and the amount of an account balance, but upon further examination, she determines that her expectation is precise enough. Which of the following best illustrates how she should proceed?

    a. She should begin treating the difference as a misstatement and post it to the summary of audit differences.

    b. She should request an explanation of the difference from her client's management or the accounting department.

    c. She should perform additional inquiry and analysis to determine if there is a risk of misstatement due to the difference.

    d. She should reduce the degree of assurance from her analytical procedures and apply additional procedures.

SELF-STUDY ANSWERS

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

4. Which of the following analytical procedures includes comparing ratios of recorded amounts to expectations developed by the auditor? **(Page 15)**

   a. Reporting the analytical procedures. [This answer is incorrect. Documenting analytical procedures is a method of using analytical procedures; however, this method does not involve comparing ratios of recorded amounts to expectations developed by the auditor.]

   b. Establishing an expectation of what an account balance should be. [This answer is correct. Analytical procedures should involve comparisons of recorded amounts, or ratios of recorded amounts, to expectations developed by the auditor which include developing an expectation of what an account balance should be, and comparing the expected amount with the recorded amount.]

   c. Studying the cause of unexpected significant difference. [This answer is incorrect. Investigating the cause of any unexpected significant difference is considered a method of using analytical procedures; however, this method does not involve comparing ratios of recorded amounts to expectations developed by the auditor.]

   d. Assessing the possibility of material misstatement. [This answer is incorrect. Evaluating the likelihood of material misstatement is considered a method of using analytical procedures; however, this method does not involve comparing ratios of recorded amounts to expectations developed by the auditor.]

5. Which of the following is an example of a substantive analytical procedure? **(Page 16)**

   a. Identifying risks of material misstatements due to fraud. [This answer is incorrect. According to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, this is a substantive procedure where the auditor is required 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, however, this is not an *analytical* procedure.]

   b. Inspecting invoices in support of additions to capital assets. [This answer is incorrect. The inspection of invoices in support of additions to capital assets is considered a substantive procedure but not an *analytical* procedure.]

   c. Substantiating the balance of the capital asset account by testing the transactions. [This answer is incorrect. The objective of the test of tests of details is to substantiate the balance of the capital asset account by testing the transactions.]

   d. Comparing an account balance with the prior-period balance. [This answer is correct. Comparing an account balance with the prior-period balance is an example of an analytical procedure because analytical procedures involve comparisons of recorded amounts to expectations developed by the auditor.]

6. Marilyn is conducting an audit of Lehman University. Which of the following should Marilyn use to increase her knowledge of the client's business? **(Page 16)**

   a. Substantive procedures. [This answer is incorrect. According to SAS No. 56, substantive procedures are used to gather audit evidence regarding potential misstatements.]

   b. Preliminary analytical procedures. [This answer is correct. If Marilyn needs to increase her knowledge regarding the client's business and assist in assessing areas of specific risk of misstatement by identifying unexpected relationships among account balances or the absence of expected relationships, she needs to utilize preliminary analytical procedures per SAS No. 56.]

c. Comprehensive review of analytical procedures. [This answer is incorrect. Once an audit has reached his or her final review stage of the audit, SAS No. 56 states that overall review analytical procedures be used to assure that the numbers make sense. Marilyn needs to obtain knowledge regarding the client's business at an earlier stage in the audit process.]

7. Which of these statements best describes substantive analytical procedures? **(Page 16)**

   a. They are part of the final review of the financial statements. [This answer is incorrect. Overall review analytical procedures, not substantive analytical procedures, are part of the final review of the financial statements. They help the auditor ensure that the numbers make sense.]

   b. They are focused on particular account balances. [This answer is correct. The auditor should have already assessed the risk of misstatement with respect to a particular account balance and then decided that the substantive analytical procedures are likely to provide reasonable assurance that the balance is not materially misstated.]

   c. They are made up of a finite set of ratios and procedures. [This answer is incorrect. No analytical procedures are considered exclusively substantive analytical procedures. The same ratios, procedures, and relationships can be used as preliminary, substantive, and overall review analytical procedures.]

   d. They are required in all audits of financial statements. [This answer is incorrect. Preliminary and overall review analytical procedures are both required parts of an audit, but the use of substantive analytical procedures is up to the discretion of the auditor.]

8. What is the first step an auditor should take when designing effective analytical procedures conformed for the client's specific situation? **(Page 18)**

   a. Inquiring of management what relationships and ratios management regards as useful when monitoring risks. [This answer is correct. 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. This method improves efficiencies and the likelihood of identifying errors in the financial statement.]

   b. Evaluating key factors that affect the prospective relationships and operations in preparing the budget. [This answer is incorrect. Considering the Government's budgetary process is a step in designing effective substantive analytical procedures that can be a valuable source of auditor expectations. The budget represents management's proposed spending and does not reflect actual expenses. This is a tool, not a control.]

   c. Utilizing industry statistics as a source of data for comparisons in performing analytical procedures. [This answer is incorrect. Best practices indicate that auditors should make greater use of industry statistics as a source of data for comparisons in performing analytical procedures. Although these comparisons provide insight on how the client's performance compares to that of similar entities, This task does not identify areas of risk. It is considered more a benchmark against which to compare the company's operations with other companies like it.]

   d. Communicating with personnel outside the financial management regarding when to design and perform analytical procedures. [This answer is incorrect. Discussions with operating management and personnel can be invaluable in learning enough about the client' operations and risks to design effective analytical procedures, however, personnel outside the financial management group usually do not have the same understanding of the financial operations of the company as would the financial management group, and therefore, would be less likely to identify significant areas or risk.]

9. When devising substantive analytical procedures, what information should auditors gain from talking with their clients' operating personnel? **(Page 20)**

   a. A feel for how the client's business really works and an understanding of the information management uses when running the business. [This answer is incorrect. Auditors can get this information by asking management about the relationships, ratios, and external and internal data it finds useful for running the business and identifying and monitoring business risks.]

b. A working knowledge of key factors affecting the client's account balances and the stability of plausible relationships. [This answer is incorrect. Auditors will find out this information by considering their clients' budgetary processes.]

c. An enhanced understanding of significant transactions and events that affect the financial statements. [This answer is correct. Such conversations might also corroborate any risk-assessment conclusions made by the auditor, lead to improvements developing expectations of recorded amounts, and more insightful evaluations of any differences from those expectations.]

d. A comparison of how a client's performance compares to that of their competitors. [This answer is incorrect. Auditors can determine this information by identifying comparables between their client and other competitors in the industry.]

10. Substantive analytical procedures are based on a projected recorded amount based on a likely relationship between that amount and financial or nonfinancial data. These procedures are favored if reliable data to develop expectations is readily available. Which of the following statements regarding the availability of reliable data is most accurate? **(Page 21)**

a. Auditors are encouraged to use data from an independent operating department. [This answer is correct. Best practices indicate that nonfinancial data from an independent operating department tends 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.]

b. Auditors are not encouraged to seek additional data if the available date is reliable. [This answer is incorrect. Generally, the auditor should exercise professional skepticism in evaluating the reliability of available data and seek more reliable data to achieve greater precision if necessary.]

11. During audit planning, Ashleigh suspects there is a risk that management has cooked the books. What specific procedures does Ashleigh recommend to address this risk? **(Page 22)**

a. Compare actual cash flow with recorded accrued amounts. [This answer is incorrect. Such procedures would generally be useful, as would comparisons of the total recorded amount with the portion dependent on a subjective estimate; however, to ensure the most effectiveness, Ashleigh will need to design substantive analytical procedures that are specific to her client and her client's industry.]

b. Analytical comparisons with a comparable entity. [This answer is correct. By comparing Ashleigh's client's activities with those of a comparable government, she can recognize unexpected relationships and develop better expectations of recorded amounts.]

c. Use certain specific ratios developed by her firm that will catch fraud in any client's financial statements. [This answer is incorrect. There are no ratios or relationships that will magically work for all clients. Ashleigh will have to devise her own substantive analytical procedures that will be effective in the context of her client and her client's industry.]

d. Substantive analytical procedures that prove whether potential misstatements were caused by fraud. [This answer is incorrect. Generally, substantive analytical procedures will not provide enough evidence to resolve the issue of potential material misstatement; however, they are both efficient and effective means of directing an auditor's attention to account balances that require more investigation.]

12. Asia is conducting an audit of the City of Goliad. Asia has developed an expected recorded amount from reliable data and compared the expectation to the recorded amount, what is her next step? **(Page 26)**

a. Determine if there is a significant difference between the actual and expected amounts. [This answer is correct. Once Asia has developed an expectation of a recorded amount or ratio of recorded

amounts from reliable data and compared the expectation to the recorded amount, her next step is to determine if there is a significant difference. If the difference is not significant, further audit work may not be necessary.]

b. Request of management and accounting personnel responsible for identified estimates, an explanation of the methods and procedures used to make the estimates. [This answer is incorrect. According to SAS No. 57, if an auditor has identified the need for estimates using knowledge of the government and the results of risk assessment procedures, the next step generally is asking management and accounting personnel responsible for identified estimates for an explanation of the methods and procedures used to make the estimates. This does not apply to identifying and evaluating significant differences.]

c. Inquire of management what relationships, ratios, and internal or external data management finds particularly useful, particularly in identifying and monitoring risks. [This answer is incorrect. According to SAS No. 110, when designing effective substantive analytical procedures, the first step an auditor should take is to ask management what ratios, relationships, and internal or external data management finds particularly useful, particularly in identifying and monitoring risks.]

d. Overall review analytical procedures. [This answer is incorrect. The overall review of analytical procedures is used in the final review stage of the audit per SAS No. 56.]

13. During the course of her audit, Asia discovers a significant difference between her expectation and the amount of an account balance, but upon further examination, she determines that her expectation is precise enough. Which of the following best illustrates how she should proceed? **(Page 27)**

    a. She should begin treating the difference as a misstatement and post it to the summary of audit differences. [This answer is incorrect. A difference should not be treated as a misstatement immediately. There are steps Asia must complete before she can decide whether the difference is an actual misstatement.]

    b. She should request an explanation of the difference from her client's management or the accounting department. [This answer is incorrect. If the difference is deemed significant, Asia would need to find an explanation; however, if an explanation is needed, she should try to obtain it from someone unrelated to the financial statement preparation.]

    c. She should perform additional inquiry and analysis to determine if there is a risk of misstatement due to the difference. [This answer is correct. This additional inquiry and analysis should allow Asia to determine if the risk of misstatement based on the difference is acceptable or not.]

    d. She should reduce the degree of assurance from her analytical procedures and apply additional procedures. [This answer is incorrect. This would be an option for Asia if she determined that her expectation was not effective enough and needed to be refined.]

OTHER ISSUES RELATED TO SUBSTANTIVE PROCEDURES—OTHER ISSUES

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. SAS No. 110 (AU 318.64) states that this evidence "is not sufficient to reduce detection risk to an acceptably low level in the current period" and observes that in most cases it "provides little or no evidence for the current period." SAS No. 110 provides 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: prior audit evidence substantiating the purchase cost of a building or building addition. 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 should perform audit procedures during the current period to establish the continuing relevance of the audit evidence. (SAS No. 106, AU 326.24) Using audit evidence about the operating effectiveness of controls obtained in prior audits is discussed in Lesson 2.

Responding to Fraud Risks

The auditor is responsible for designing the audit to detect material misstatements, whether caused by error or fraud. The auditor does not routinely select procedures designed solely to detect fraud in ordinary circumstances. However, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU 316), requires the auditor 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, SAS No. 99 also requires auditors to perform certain specific procedures to address the risk of management override of controls, including examining the entity's journal entries and other adjustments, reviewing accounting estimates for bias, and evaluating the business rationale for significant unusual transactions.

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 generally 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 generally 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.

If inherent risk is assessed at high because of the presence of fraud risks, the auditor might decide to increase the extent of procedures (for example, by performing analytical procedures at a more detailed level, obtaining a higher percentage of coverage when performing scope testing, or increasing sample sizes). A more likely response, however, might be to modify the nature of audit procedures in the area of concern rather than the extent. Examples of specific responses affecting the nature, timing, and extent of procedures are included in Exhibit 1-3.

Exhibit 1-3

Examples of Specific Responses to Fraud Risks

Nature of Audit Procedures

- Obtain evidence from more independent sources.
- Perform more physical observation and inspection procedures.
- Contact major suppliers and customers orally.
- Send confirmation requests to a specific party in an organization.
- Seek more or different information.
- Use computer-assisted audit techniques to gather more extensive evidence or perform different types of tests.
- Perform a different combination of substantive tests of details and analytical procedures.
- Interview personnel involved in areas where identified fraud risks exist to obtain their insights about the risk and whether or how controls address the risk.
- If the work of specialists is especially significant to the financial statements, engage another specialist or perform additional procedures on the assumptions, methods, and findings.
- Confirm with customers relevant contract terms and the absence of side agreements. (Maybe even confirm both orally and in writing.)
- Apply additional procedures during inventory observation, such as more rigorously examining product contents or quality, or the way boxes are stacked.
- Apply additional procedures to inventory tags, count sheets, etc.
- Obtain a further understanding of and test controls over assets that are highly prone to misappropriation.

Timing of Audit Procedures

- Confirm receivables at year end rather than at interim.
- Perform certain procedures on a surprise or unannounced basis.
- Observe inventory at all locations at once.
- Request physical inventories to be taken at or near year end.
- Apply substantive procedures to transactions occurring throughout the period under audit.

Extent of Audit Procedures

- Increase sample sizes.
- Obtain a higher percentage of coverage when performing scope testing, for example, by reducing the scope for detail tests of expense accounts.
- Observe inventory at special locations or all locations.
- When using the work of other auditors, discuss with them the extent of work needed to address identified fraud risks resulting from transactions and activities involving the two entities or components.
- Additional testing of inventory tags, count sheets, etc.
- Perform substantive analytical procedures, including the development of an expected dollar amount, using disaggregated data to achieve a high level of precision.
- Use computer-assisted audit techniques to test an entire population instead of a sample.

* * *

Professional Skepticism. When gathering and evaluating audit evidence in response to identified fraud risks, auditors must 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 extensive substantive testing of the balance recorded 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. In addition, some of the responses listed in Exhibit 1-3 might apply. Deciding which procedures are necessary is left to the judgment of the auditor. SAS No. 99 (AU 316.56) states that the scope of work should 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. See further discussion below.

Generally, the auditor will consider 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 transactions (for example, in purchasing or payroll disbursements).

If, after considering 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:

- Reviewing selected disbursements for unusual payees, signatures, or endorsements.

- Reviewing vendor lists for unusual patterns.

- 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 accordance with professional standards. In addition, the auditor should consider working with the client, when necessary, to establish effective controls over disbursements.

Cost of Assets Stolen. Another 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, the asset still on hand at the date of the financial statements is accurately reflected on the balance sheet, and the theft is washed through as an expenditure or expense. Practitioners disagree on whether such financial statements are materially misstated, and SAS No. 99 does not attempt to resolve the issue. It simply points out that "misstatements arising from misappropriation of assets (sometimes referred to as theft or defalcation) involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP" (AU 316.06). In other words, the issue of whether such financial statements are materially misstated is a GAAP 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, some consideration also should be given to the qualitative aspects of materiality. For example, in some cases, implications of potential misstatements that might otherwise be immaterial could be significant to financial statement users because they involve misappropriation of assets.

If auditors conclude that an audit response is necessary to detect the costs of misappropriated assets reflected in financial statements, they generally would respond by modifying the nature, timing, or extent of procedures ordinarily used to test income statement accounts. Income statement accounts are ordinarily tested through analytical procedures, tests of transactions, scanning for unusual amounts, or some combination thereof. SAS No. 99 states that the use of analytical procedures, including the development by the auditor of an expected dollar amount at a high 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, SAS No. 99 requires auditors to address that risk. In addition to the auditor's overall and specific responses to identified fraud risks, SAS No. 99 requires auditors to 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 rationale for significant unusual transactions.

Examining Journal Entries. 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. Examining the entity's journal entries involves obtaining an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments, selecting entries for testing, and determining the nature and timing of tests. Auditors should also make inquiries of employees involved in financial reporting about the possibility of unusual or improper journal entry activity, including unsupported entries. Tests ordinarily should focus on entries made at or near year end. Auditors also may consider scanning the general ledger immediately following year end for unusual entries, including entries that were reversed at the beginning of the subsequent period. Auditors should consider placing greater emphasis on entries not subject to the entity's normal internal controls (such as nonrecurring and post-closing entries).

When selecting journal entries for testing and designing tests, auditors should 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.

Determining the nature, timing, and extent of tests of journal entries is a matter of professional judgment. However, procedures should include examining the general ledger to identify entries for testing and reviewing supporting documentation. Considerations include whether entries are properly approved, adequately supported, and properly posted, and whether they appropriately reflect the underlying events and transactions. For most audits, best practices indicate that tests of journal entries will be performed at year end. If examination of the ledger to identify entries for testing is initially performed before year end, those procedures should be extended to year end.

Reviewing Accounting Estimates. SAS No. 107 (AU 312.58) suggests 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.

SAS No. 99 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 should evaluate 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.

Evaluating Significant Unusual Transactions. SAS No. 99 requires auditors to gain an understanding of the business rationale for significant unusual transactions. Understanding the business purpose (or lack thereof) for transactions outside the normal course of operations may provide an indication that transactions were entered into for the purpose of engaging in fraudulent financial reporting or to conceal misappropriation. In evaluating business rationale, auditors should consider whether:

- The transaction is overly complex in relation to its stated purpose.

- Management is overly concerned that the transaction receives a particular accounting treatment.

- The transaction involves previously unidentified related parties.
- The parties to the transaction lack substance.
- The transaction and the manner of accounting have been reviewed and approved at an appropriate level, such as by the governing board or audit committee.
- The transaction makes business sense from the perspective of the other party.

Effect on Audit Programs. Auditors use professional judgment in determining the nature, timing, and extent of the procedures that should be performed to respond to identified fraud risks. If the auditor chooses to respond to fraud risks by changing the nature of his or her 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.

Due to the nature of fraud and the methods in which it may be committed, it is not possible to develop a comprehensive set of standardized procedures that should be performed in response to an auditor's assessment of fraud risks. In some cases, the auditor may need to develop his or her own procedures in response to specific facts and circumstances of the engagement.

Documenting Fraud Risk Responses. SAS No. 99 (AU 316.83) requires the auditor to document responses to risks of material misstatement due to fraud. The auditor is required to document the following:

- The responses to identified fraud risks.
- The results of procedures to address the risk of management override of controls.
- Additional conditions, if any, requiring a response and the response(s) to those conditions.

The SAS 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. 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 not very effective in testing completeness. However, an AICPA auditing interpretation (AU 9326.24–.27) states that a reduced assessment of control risk is not 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 should restrict 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.)

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. Although management representations are not a substitute for other audit procedures and, according to the audit interpretation, may not be solely relied on, the representations can complement other procedures.

SUBSTANTIVE PROCEDURES—TIMING

As part of audit planning, an auditor can consider whether any substantive procedures should be applied before the balance sheet date. Generally, the most efficient approach for audits of small local governments is to perform the audit tests as of the balance sheet date. However, the auditor may wish to perform audit procedures before the balance sheet date in the following situations:

- *Convenience.* If the auditor has several clients with the same year end, interim procedures may be used to spread the auditor's workload more evenly.

- *Deadline.* If the client has a tight deadline for issuing its financial statements, the auditor may need to perform some procedures at an interim date to meet that deadline.

- *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 SAS No. 99 points out (AU 316.52), 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. SAS Nos. 99 and 110 also suggests that 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 should 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 would be completed as part of year-end procedures.

Audit Risk Considerations

When interim audit procedures are performed, there is a risk that the conclusions reached at the interim date are not extended properly to the balance-sheet date. This remaining period 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 to perform substantive procedures at an interim period, the auditor should consider whether the tests that would be performed for the remaining period will adequately reduce the risk that misstatements that exist at period end are not detected.

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 statements regarding responding to fraud risks is most accurate?

    a. An auditor may modify the nature of procedures performed based on his or her assessment of fraud risks.

    b. Auditors should regularly choose procedures intended solely to detect fraud in normal circumstances.

    c. Auditors should not rely entirely on tests of controls to reduce audit risk to an appropriate level.

15. What type of response would an auditor use to address the risk of fraud at the account balance level?

    a. Overall responses.

    b. Specific responses.

16. Which of the following specific responses to fraud risk changes the timing of the audit procedures?

    a. Observe inventory at all locations at once.

    b. Send confirmation requests to a specific party in an organization.

    c. Contact major suppliers, donors, or contributors orally.

    d. Use computer-assisted audit techniques to test the entire population.

17. Jack is conducting an audit of City of Yorktown. Jack discovers evidence of material misstatement of the financial statements due to misappropriation of assets. What does this lesson suggest is the *most* appropriate way to respond to these findings?

    a. Verify with customers significant contract terms and the absence of side agreements.

    b. Confirm receivables at year end rather than at interim.

    c. Conduct extensive substantive testing of the balance recorded in the financial statements.

    d. Perform a higher percentage of coverage when testing scopes.

18. Which of the following should an auditor perform once he or she has determined the risk of fraudulent disbursements in a government audit could be material?

    a. Consider the client's controls over disbursements regarding segregation of duties.

    b. Assess selected disbursements for atypical endorsements.

    c. Assess vendor lists for unusual patterns.

    d. Performing paymaster procedures.

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.)**

14. Which of the following statements regarding responding to fraud risks is most accurate? **(Page 37)**

    a. An auditor may modify the nature of procedures performed based on his or her assessment of fraud risks. [This answer is incorrect. 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 per SAS No. 99.]

    b. Auditors should regularly choose procedures intended solely to detect fraud in normal circumstances. [This answer is incorrect. The auditor is responsible for designing the audit to detect material misstatements, whether caused by error or fraud. The auditor does not routinely select procedures designed solely to detect fraud in ordinary circumstances per SAS No. 110.]

    c. Auditors should not rely entirely on tests of controls to reduce audit risk to an appropriate level. [This answer is correct. Tests of controls alone generally will not reduce audit risk to an appropriately low level because of the risk of management override of controls; therefore, tests of controls alone are generally not sufficient to respond to fraud risks.]

15. What type of response would an auditor use to address the risk of fraud at the account balance level? **(Page 37)**

    a. Overall responses. [This answer is incorrect. This type of response is generally used to address fraud risks that are pervasive to the financial statements. They affect the overall strategy of the audit.]

    b. Specific responses. [This answer is correct. This is the type of response to fraud risk at the account balance, transaction class, or financial statement assertion level. Such responses involve the nature, timing, and extent of further audit procedures.]

16. Which of the following specific responses to fraud risk changes the timing of the audit procedures? **(Page 28)**

    a. Observe inventory at all locations at once. [This answer is correct. This response changes the timing of the audit procedures. Another example would be to confirm receivables at year end instead of at an interim date.]

    b. Send confirmation requests to a specific party in an organization. [This answer is incorrect. This response to fraud risk affects the nature of the audit procedure.]

    c. Contact major suppliers, donors, or contributors orally. [This answer is incorrect. The nature of the audit procedure would be changed if the auditor chose to use this specific response to fraud risk.]

    d. Use computer-assisted audit techniques to test the entire population. [This answer is incorrect. This response would affect the extent of the audit procedure, not the timing.]

17. Jack is conducting an audit of City of Yorktown. Jack discovers evidence of material misstatement of the financial statements due to misappropriation of assets. What does this lesson suggest is the *most* appropriate way to respond to these findings? **(Page 39)**

    a. Verify with customers significant contract terms and the absence of side agreements. [This answer is incorrect. If Jack confirms with customers relevant contract terms and the absence of side agreements, he would be responding to fraud risks by changing the nature of audit procedures.]

    b. Confirm receivables at year end rather than at interim. [This answer is incorrect. If Jack confirms receivables at year end rather than at the interim, he would be responding to fraud risks by altering the timing of audit procedures.]

c. Conduct extensive substantive testing of the balance recorded in the financial statements. [This answer is correct. Auditors may be faced with unique considerations when determining how to respond to the risk of material misstatement due to misappropriation of assets. 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 extensive substantive testing of the balance recorded in the financial statements.]

d. Perform a higher percentage of coverage when testing scopes. [This answer is incorrect. If Jack obtains a higher percentage of coverage when performing scope testing he would be responding to the fraud risk by modifying the extent of audit procedures.]

18. Which of the following should an auditor perform once he or she has determined the risk of fraudulent disbursements in a government audit could be material? **(Page 39)**

a. Consider the client's controls over disbursements regarding segregation of duties. [This answer is correct. Generally, the auditor will consider the client's controls over disbursements, such as segregation of duties and effective management oversight (for example, a senior official receives the bank statement unopened), and authorization and approval of transactions (for example, in purchasing or payroll disbursements). This lesson suggests performing these procedures prior to determining that controls and the risk that fraudulent disbursements could be material to the financial statements.]

b. Assess selected disbursements for atypical endorsements. [This answer is incorrect. This lesson suggests reviewing selected disbursements for unusual payees, signatures, or endorsements once the auditor has determined that the risk of fraudulent disbursements may be material and an additional audit response is necessary.]

c. Assess vendor lists for unusual patterns. [This answer is incorrect. This lesson suggests reviewing vendor lists for unusual patterns once the auditor has determined that the risk of fraudulent disbursements may be material and additional audit response is necessary.]

d. Performing paymaster procedures. [This answer is incorrect. This lesson suggests performing paymaster procedures once the auditor has determined that the risk of fraudulent disbursements may be material and additional audit response is necessary.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (ALGTG101)

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

1. What should an auditor consider when planning further audit procedures for an audit of a governmental entity?

   a. Nature and source of evidence.

   b. Balance sheet accounts and classes of transactions.

   c. The auditor's requirement to report on opinion units and the government's use of funds.

   d. Operating and related accounting data.

2. Which of the following is **not** acceptable when an auditor's approach to significant risks does not include reliance on controls?

   a. Only substantive analytical procedures.

   b. Only tests of details.

   c. Combination of substantive analytical procedures and test of details.

   d. Do not select this answer choice.

3. In the context of SAS No. 106, what is the sufficiency of audit evidence that an auditor must consider when choosing additional substantive procedures?

   a. Reliability.

   b. Appropriateness.

   c. Quantity.

   d. Quality.

4. Which of the following statements regarding choosing the appropriate substantive procedures is most accurate?

   a. The higher the auditor's assessment of risk, the less reliable and relevant is the audit evidence required by the auditor from tests of details.

   b. Generally, auditors are less likely to use analytical procedures more extensively in high risk audit areas and test of details more often in low risk areas.

   c. Generally, if the assessed risk of material misstatement is elevated, the more effective analytical procedures should be before they can be relied on instead of tests of details.

   d. If the residual risk of material misstatement is low, the quantity and quality of required audit evidence from substantive procedures should increase.

5. Generally, when are tests of details more effective than analytical procedures?

   a. When interest rates are widely fluctuating.

b. When some account balances are disproportionately large.

c. When there is a greater than normal risk of cooking the books.

d. When the risk of misstatement has been assessed as being primarily from error.

6. Which of the following is true regarding tests of transactions and tests of balances?

   a. Tests of transactions are more efficient than tests of details.

   b. Each affects a related account balance.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

7. Which of the following statements correctly describes tests of details?

   a. Performing tests of controls eliminates the need for tests of details.

   b. Documentation of tests of significant items should identify items by date and specific number.

   c. Tests of balances are usually more efficient and effective than tests of transactions.

   d. Tests of details can only be applied to transactions or balances, but not both.

8. What determines whether a test is a substantive procedure or a test of controls?

   a. Objective of the test.

   b. If the test is applied to a class of transaction.

   c. If the test is applied to a balance.

   d. Operating effectiveness.

9. Which of the following **two** procedures are required in a financial statement audit?

   a. Substantive and preliminary.

   b. Overall review and preliminary.

   c. Overall review and substantive.

   d. Do not select this answer choice.

10. Which of the following procedures tends to be more useful as the fundamental procedure when the risk of misstatement has been determined as resulting from an error?

    a. Preliminary analytical.

    b. Overall review analytical.

    c. Substantive analytical.

    d. Risk assessment.

11. Which of the following best describes substantive analytical procedures?

    a. They focus on a single direction—overstatement or understatement.

    b. They are less useful when misstatement risk is primarily from error.

    c. They cannot be used for fraud detection.

    d. They can be used to test for overstatements and understatements simultaneously.

12. When performing analytical procedures, which of the following allows auditors to identify issues and problems, and allows corrective actions to be implemented before year end work begins?

    a. Moving additional audit work to interim dates.

    b. Corroborating explanations.

    c. Focusing on trends.

    d. Testing controls.

13. If an auditor's goal when performing roll-forward procedures is _______, analytical procedures can be particularly beneficial.

    a. to evaluate if the recorded amount of transactions between the interim date and the balance-sheet date is reasonable in relation to the auditor's expectation.

    b. to evaluate the key factors that affect future operations and the relationships among these factors.

    c. to evaluate significant accounting estimates made by management.

    d. to evaluate 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.

14. In what instance does SAS No. 110 condone using audit evidence from substantive procedures performed in a prior audit?

    a. When the auditor's expectation amounts are the same as in the prior audit.

    b. When the tolerable misstatement amount has not been exceeded.

    c. When the auditor determines there is no risk of material misstatement due to fraud.

    d. When used to substantiate the purchase cost of a building or building addition.

15. Whoopie's audit client keeps a large stock of valuable items on hand which are small enough to be easily stolen. This makes the client's assets particularly susceptible to misappropriation. Which of the following procedures would be specifically targeted to respond to this fraud risk?

    a. Engaging a specialist to perform additional procedures.

    b. Increasing sample sizes.

    c. Obtaining information from independent sources.

    d. Physically inspecting the assets at year end.

16. Charles is conducting an audit of Mountain Scene University. He is responsible for designing the audit to detect material misstatements, whether caused by error or fraud. In planning the audit, Charles decides to perform an unannounced specific procedure. This is what type of specific response to fraud risks?

    a. Timing of audit procedures.

    b. Extent of audit procedures.

    c. Nature of audit procedures.

    d. Do not select this answer choice.

17. Martha is conducting an audit of Lakeside University. Martha is also responsible for designing the audit to detect material misstatements, whether caused by error or fraud. In designing the audit, Martha uses computer-assisted techniques to obtain additional information or perform various types of tests. Which of the following specific response is Martha performing?

    a. Extent of audit procedures.

    b. Nature of audit procedures.

    c. Timing of audit procedures.

    d. Do not select this answer choice.

18. Lloyd is auditing Southern University. After considering the controls and the risk that any fraudulent disbursements would be material to the entity's financial statements, Lloyd decides an additional audit response is required. Which of the following procedures could he consider?

    i. Reviewing selected disbursements for unusual endorsements, signatures, or payees.
    ii. Examine the company's journal entries and other adjustments.
    iii. Performing paymaster procedures (such as observing the distribution of payroll checks).
    iv. Review accounting estimates for bias.
    v. Reviewing vendor lists for any unusual patterns.
    vi. Determine the propriety of functional expense allocation by performing analytical procedures.

    a. i, iii, v.

    b. i, ii, and v.

    c. iii and iv.

    d. iv and vi.

Lesson 2: Testing Internal Control

INTRODUCTION

To assess control risk for specific financial statement assertions at less than high in order to reduce the scope of substantive procedures, the auditor is required to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls. That is done by performing tests of the operating effectiveness of controls. However, the auditor is not required to assess control risk at less than high for any relevant assertions unless substantive procedures alone will not provide sufficient audit evidence (that is, substantive procedures alone are not effective). Therefore, in most cases, the decision about whether to test the operating effectiveness of controls is a matter of audit efficiency.

This lesson discusses tests of the operating effectiveness of controls, including circumstances when tests of controls should be performed and circumstances when testing is unnecessary or inefficient. The lesson discusses the nature of tests of controls, including inquiry and observation, inspection of documents, walkthroughs, review of reconciliations and similar bookkeeping routines, and reperformance of control activities. It also discusses other considerations that are relevant when a decision is made to test controls, such as the timing of tests, including rotation of control tests when evidence from prior audits is used, the extent of tests, efficiency opportunities, testing IT controls, documentation requirements, and related PPC practice aids. Guidance is also provided on evaluating the audit evidence obtained from performing tests of the operating effectiveness of controls and the amount of audit evidence necessary to support the control risk assessment.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine when tests of controls should be performed and identify efficiency opportunities in testing controls.
- Develop a control risk assessment.
- Select and apply appropriate substantive procedures.

Specialized Considerations for Governmental Units

Governmental units are different from other types of entities due to the public nature of their operations and related attention they receive from the news media. These factors combine to create significant potential for adverse publicity for both the governmental unit and the auditor if something goes wrong. As a result, the auditor may need to be concerned with internal controls over matters that are immaterial to the governmental unit's financial statements.

Auditors of governmental financial statements issue an opinion on each opinion unit rather than the entity as a whole. Therefore, the auditor's consideration of internal control in planning and performing the audit should address each opinion unit.

Many governmental entities or other entities receiving government funds are required to have audits performed under *Government Auditing Standards* (the Yellow Book). Those standards establish additional requirements for communications about internal control. Paragraph 4.06 of the Yellow Book states that auditors should communicate the nature of the planned work and level of assurance to be provided on internal control over financial reporting. This communication should be (a) in writing, (b) made during audit planning, and (c) made to management, those charged with governance, and the individuals contracting for or requesting the audit. *Government Auditing Standards* also require auditors to issue a written report on internal control over financial reporting.

Many governmental units undergo a compliance audit or a Single Audit in addition to a financial statement audit. The internal control considerations for such audits will likely impact the internal control considerations for the financial statement audit.

Authoritative Literature

The authoritative pronouncements that establish requirements or provide guidance that most directly affect tests of controls are as follows:

- SAS No. 39 (AU 350), *Audit Sampling*, as amended by SAS No. 111, provides guidance for sample selection, sample size determination, and evaluation when tests of controls are performed using audit sampling.

- SAS No. 117 (AU 801.20), *Compliance Audits*, indicates circumstances when further audit procedures in response to the assessed risk of material noncompliance should include performing tests of controls over compliance. The standard also notes, at 801.A25, that "some governmental audit requirements, for example, OMB Circular A-133, require tests of the operating effectiveness of controls identified as likely to be effective, even if the auditor believes that such testing would be inefficient."

- SAS No. 108 (AU 311), *Planning and Supervision*, indicates that the audit plan should reflect the auditor's decision about whether to test the operating effectiveness of controls. It also provides guidance on determining whether an IT specialist may be necessary to determine the effect of IT on the audit, including understanding and testing computer related controls.

- SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, discusses how the results of tests of controls may impact the preliminary risk assessment and planned audit procedures. It also describes those risks for which control tests are necessary because substantive procedures alone do not provide sufficient appropriate audit evidence.

- SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, provides guidance on (1) determining when tests of controls may be appropriate, (2) the nature, timing, and extent of control tests, (3) evaluating the sufficiency and appropriateness of audit evidence collected, and (4) documentation requirements.

- SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, provides guidance on the auditor's responsibility to communicate significant deficiencies and material weaknesses in internal control to management and those charged with governance.

- GAO *Government Auditing Standards* (the Yellow Book). The Yellow Book incorporates GAAS and adds other requirements that apply to financial audits of entities of federally assisted programs.

- OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*, provides detailed guidance for implementing the provisions of the Single Audit Act Amendments of 1996.

- AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), includes guidance unique to governmental units concerning tests of controls.

- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide), provides guidance on the auditor's responsibilities when conducting financial statement audits performed under *Government Auditing Standards* and Single or program-specific Audits in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133.

- AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (referred to as the AICPA Risk Assessment Guide), provides guidance on performing further audit procedures, including tests of controls.

- AICPA Audit Guide, *Audit Sampling*, (referred to as the AICPA Sampling Guide) provides guidance on designing and performing audit sampling, including the use of nonstatistical and statistical sampling for tests of controls.

The authoritative pronouncements are explained further at the relevant points in this lesson.

The Auditing Standards Board is completing its large-scale project to redraft and revise all existing U.S. auditing standards to improve clarity and to converge with the International Standards on Auditing (ISAs). The ASB anticipates that the redrafted and clarified SASs, except those that address current issues, will be effective for audits of financial statements no earlier than for periods beginning on or after December 15, 2010. Standards that address current issues could have earlier effective dates.

AN OVERVIEW OF INTERNAL CONTROL TESTING

As part of every financial statement audit, the auditor obtains an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. SAS No. 109 (AU 314.40) states that the understanding should include an evaluation of the design of controls and a determination of whether they have been implemented.

However, the evaluation of control design and implementation serve a different purpose than tests of controls (the subject of this lesson). The evaluation of control design and implementation, which is accomplished through the performance of risk assessment procedures, is necessary to assess the risk of material misstatement of the financial statements. The combined risk of material misstatement includes a control risk component. Based on that assessment, the auditor determines which further audit procedures to perform. Further audit procedures may include tests of the operating effectiveness of controls, as well as substantive procedures.

Unlike the evaluation of control design and implementation, which is required in every audit, tests of controls, which are categorized as further audit procedures, are not required in every audit. In addition, when control tests are performed, controls would not generally be tested for every significant class of transactions, account balance, disclosure, or relevant assertion.

In addition, as explained in SAS No. 110 (AU 318.26), testing the operating effectiveness of controls is different from obtaining evidence that controls have been implemented. Implementation means that the controls exist and are being used. Operating effectiveness relates to how and by whom controls are applied and the means by which, and consistency with which, the controls are applied.

After testing controls, the auditor evaluates the sufficiency and appropriateness of audit evidence obtained to reach a conclusion about the operating effectiveness of the controls tested. If necessary, the auditor modifies the initial control risk assessment (and combined risk of material misstatement) and reconsiders the nature, timing, and extent of planned substantive procedures.

Practical Considerations Related to Tests of Controls

Answers to the following auditor questions about tests of controls can be found later in this lesson:

- When is it necessary or required to test controls?
- To what extent can the control risk assessment be reduced based on risk assessment procedures performed to understand the design and implementation of controls?
- When is it not efficient to test controls?
- For what periods of time should tests of controls be performed?
- Can evidence obtained from tests of controls in prior audits be used in the current audit?
- How can controls be tested most efficiently?
- What needs to be considered when testing computer application controls?
- If controls are tested, how extensive should the tests be? Also, how much evidence is necessary to support a control risk assessment of "moderate" rather than "high?"

- How much audit effort can be saved by reducing the control risk assessment to "moderate" rather than "high?"

- What are the documentation requirements related to tests of controls, and how can the auditor document such tests?

- Whether (and, if applicable, which) additional Yellow Book or Single Audit requirements need to be considered? (Yellow Book requirements are discussed where relevant throughout this lesson.

Basic Approach to Tests of Controls

The following basic steps normally apply when considering tests of controls:

Step 1 *Identify audit areas where tests of controls are necessary or efficient*.

Step 2 *Decide which controls to test.*

Step 3 *Select appropriate procedures.*

Step 4 *Perform tests of controls*.

Step 5 *Evaluate the results of the tests and, if necessary, revise the initial control risk assessment and the risk of material misstatement*.

Step 6 *Document the tests of controls.*

These steps may overlap or be performed in a varying order. For example, based on the initial audit strategy, the auditor may decide to test operating effectiveness concurrently with evaluating design and implementation. Auditors often decide which controls to test (Step 2) when considering whether testing will be efficient (Step 1). Also, documentation of the tests of controls (Step 6) might be done as the work progresses. However, the step-by-step approach to tests of controls presents a logical framework for the considerations that are normally required. The remainder of this lesson discusses each of those steps in further depth.

Specialized Considerations for Governmental Units

Auditors of governmental units should be alert for evidence of control effectiveness that can be obtained from external sources, such as federal grantor reviews. For example, some federal agencies perform annual reviews of their programs, including internal controls, which result in the issuance of written reports. This external evidence can assist the auditor in assessing the effectiveness of controls. Larger governments may have an internal audit department that assesses and tests internal controls throughout the year. The auditor should become familiar with the results of the internal audit department's internal control work.

CHOOSING TO TEST CONTROLS

SAS No. 110 (AU 318.23) indicates that tests of controls should be performed in the following circumstances:

- When the auditor's risk assessment includes an expectation of the operating effectiveness of controls. In that case, audit evidence is obtained to support the operating effectiveness of those controls. In other words, the understanding of internal control design and implementation allows the auditor to make an initial assessment that incorporates the auditor's expectations about the operating effectiveness of controls. When the auditor makes a reduced control risk assessment, the auditor performs tests of controls to obtain the necessary audit evidence to support that expectation.

- When substantive procedures alone do not provide sufficient appropriate evidence at the relevant assertion level (that is, when substantive procedures alone are not effective to achieve audit objectives related to a relevant assertion).

The auditor decides whether to test controls for relevant assertions in each audit area based on the preliminary assessment of the risk of material misstatement. In other words, the decision to test controls is made on an assertion-by-assertion basis for each audit area. Those decisions may result in audit responses at the relevant assertion level that consist of substantive procedures alone or a combination of substantive procedures and tests of controls.

Specialized Considerations for Governmental Units

Consideration of Opinion Units. The auditor's consideration of whether tests of controls are appropriate in the audit of a governmental entity is done in the context of opinion units. If the internal control for a transaction cycle is handled by the same system regardless of where the transactions and balances are reported in the financial statements, the auditor's consideration of internal control and assessment of control risk for that system would apply equally to all affected opinion units, even if transactions and balances reported in an individual opinion unit are not included in a test of controls. (However, when designing substantive procedures for financial statement assertions, the auditor needs to design audit procedures that will provide appropriate substantive evidence for a separate opinion on each opinion unit.)

Consideration of Financial Statement Reconciliations. Most governments maintain their primary accounting records on the basis of individual funds and separately develop the additional information needed for the government-wide financial statements. While much of that additional information is presented in reconciliations between the fund financial statements and the government-wide financial statements (such as capital asset and long-term debt information), some additional information is not displayed in the reconciliations (such as the eliminations and reclassifications of internal service fund activities). The auditor needs to consider internal controls over the additional information developed for the government-wide financial statements.

Consideration of Single Audit Requirements. Generally, the auditor is required to perform tests of controls over compliance in a Single Audit. The auditor may be able to achieve efficiencies in the governmental entity's financial statement audit by using evidence about a control's design and operating effectiveness obtained when performing the required testing in the Single Audit.

The Risk Assessment Includes an Expectation of Operating Effectiveness

The auditor needs to know enough about internal control to assess the risk of material misstatement for relevant assertions for account balances, transaction classes, and disclosures. When the auditor's risk assessment for a relevant assertion in an audit area includes an expectation of the operating effectiveness of controls, it means the auditor has:

- Obtained a sufficient understanding of the specific controls that are likely to prevent or detect and correct material misstatements in the relevant assertion.
- Evaluated the design of those controls and is satisfied that they are capable of preventing or detecting and correcting a material misstatement in the relevant assertion.
- Determined that the controls exist and are being used.
- Decided to rely on the effective operation of those controls when designing substantive procedures.

In other words, the auditor plans to reduce the control risk assessment based on the expectation that controls are operating effectively and to design substantive procedures that provide sufficient additional audit evidence to reduce detection risk to an appropriately low level. In order to reduce the control risk assessment, the auditor should obtain audit evidence supporting his or her expectation that such controls are operating effectively. Therefore, the audit approach consists of a combination of tests of controls and substantive procedures that provide sufficient audit evidence about the assertion being tested.

An expectation of operating effectiveness typically means that the auditor's planned control risk assessment is less than "high." In some cases, the combined risk of material misstatement can be assessed at a moderate or low level even though control risk is assessed as high. That might be the case, for example, when inherent risk is low or moderate. In that case, there is no expectation of operating effectiveness and, thus, no tests of controls would be performed. The auditor would design substantive procedures that address the combined assessed level of risk without considering the effectiveness of controls.

There may be instances when the auditor is unable to identify controls in place that would prevent or detect and correct material misstatements in specific relevant assertions. In such cases, which may occur in very small entities, testing controls would not be a consideration. However, SAS No. 110 (AU 318.10) states that in cases involving very small entities where the auditor has not identified many control activities, the auditor should consider whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Without properly designed and implemented controls, the auditor does not have a basis for an expectation of operating effectiveness. Consequently, reliance on controls in that situation is not appropriate and control risk is normally assessed as high.

The auditor may conclude that controls are appropriately designed and implemented, but may nevertheless decide that additional tests of operating effectiveness are not warranted. In that case, the auditor does not include his or her expectation of operating effectiveness when making the risk assessment (that is, the auditor does not reduce the control risk assessment). Among other reasons, this decision might be based on the following:

- Materiality and inherent risk considerations.
- Feasibility of performing tests.
- Audit efficiency considerations.

Materiality and Inherent Risk Considerations. After gaining an understanding of the entity and its environment, including its internal control, the auditor first considers the materiality and inherent risk related to specific audit areas or assertions when determining the appropriate response. A reduction of the extent of substantive procedures might be possible based on materiality considerations and the inherent risk assessment alone. In that case, no further attention to control risk or tests of controls would generally be necessary for those areas or assertions unless performed as part of a Single Audit.

<u>Materiality Considerations in the Audit of a Governmental Unit.</u> In the audit of a governmental unit, the auditor makes separate materiality evaluations for each opinion unit. Occasionally, the terms of the engagement may require the auditor to set the scope of the audit and assess materiality at a more-detailed level than by the opinion units required for the basic financial statements (for example, at an individual fund level). In many cases, the more-detailed level is required by legal or contractual provisions, such as state law, debt covenants, or grant agreements.

For audits performed under *Government Auditing Standards*, the Yellow Book, at Paragraph 4.26, indicates that it might be appropriate to use lower materiality levels in Yellow Book audits due to the public accountability of governmental entities and entities receiving government funding, legal and regulatory requirements, and the visibility and sensitivity of government programs.

Feasibility of Performing Tests. In deciding whether to test controls, the auditor should consider whether the amount and persuasiveness of available evidence would be adequate to support the planned reduced control risk assessment. For example, based on the nature of the control, observation and inquiry may be the only procedures that can be used to determine effective operation. Obviously, if the auditor determines that the control needs to be tested throughout the year, observing the performance of the control when the auditor was not present would not be possible. Since inquiry alone is not sufficient when testing controls, there may be insufficient persuasive evidence available to support a reduced assessment of control risk. Likewise, if the planned test of controls involves inspecting documents, the auditor should be sure that such documentation is available for the entire period being audited.

Audit Efficiency Considerations. In some cases, the auditor may elect to exclude his or her expectation of operating effectiveness from the relevant risk assessment for efficiency reasons. That may be the case when testing the operating effectiveness of controls would be inefficient and substantive procedures alone are considered effective. SAS No. 110 (AU 318.8) states the following:

> In some cases, the auditor may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, the auditor may exclude the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because *testing the operating effectiveness of controls would be inefficient.* (Emphasis added)

Excluding the effect of controls from the relevant risk assessment would mean assessing control risk as high regardless of the auditor's expectation that controls may be operating effectively. In other words, even in situations where the auditor has made a preliminary assessment that controls may be operating effectively based on his or her evaluation of the design and implementation of controls that would be capable of preventing or detecting and correcting material misstatements, the auditor may ultimately decide to assess control risk as high for purposes of audit efficiency and perform only substantive procedures. In order to make that decision, however, the auditor must be satisfied that substantive procedures alone would be an effective response.

Even if testing the operating effectiveness of controls is deemed to be inefficient, the auditor should still perform sufficient risk assessment procedures to have an appropriate basis for assessing the risk of material misstatement, including the determination that substantive procedures alone are effective. The assessment is a focused consideration of what could go wrong at the assertion level. If the effect of controls is excluded from the relevant risk assessment, that means the auditor's response in substantive procedures has to be adequate to deal with all those things that the inherent risk assessment indicates could go wrong. Also, the risk assessment procedures performed have to be sufficient to obtain the understanding of the entity and its environment, including internal control, to make that decision. In other words, the assessment of the risk of material misstatement at the assertion level cannot be made without the understanding of internal control. However, assuming substantive procedures alone are effective, the auditor is allowed to perform substantive procedures only and not test controls even when controls are believed to be suitably designed and implemented.

Some auditors have traditionally adopted (or defaulted to) a strategy that focuses primarily on the use of substantive audit procedures based on a belief that substantive procedures alone are effective and testing controls would never be efficient. Best practices indicate that auditors caution against such an attitude because it may result in overlooking opportunities for greater audit efficiency and effectiveness. Since the auditor is required to obtain an understanding of internal control, the auditor may identify controls that are capable of preventing or detecting and correcting material misstatements for relevant assertions. Even in small governmental units, effective controls may exist that could impact the nature, timing, or extent substantive procedures. Auditors should thoughtfully consider the results of their understanding of internal control when making a decision about the feasibility or efficiency of testing controls. Decisions about testing controls should normally be made on an assertion-by-assertion level based on the preliminary assessment of control risk. Therefore, efficiency decisions should normally be considered at the assertion level rather than at a global level for the entity as a whole. Also, even in situations where the auditor may initially conclude after performing risk assessment procedures that testing controls would not be efficient for an audit area, subsequent audit evidence might reveal that testing controls would either be more efficient or would be required to adequately address audit risk.

The auditing standards do not provide guidance for determining when tests of controls would be efficient. (The AICPA Risk Assessment Audit Guide does, however, provide some considerations that are incorporated into the following discussion.) In practice, tests of controls (specifically, tests of transactions) ordinarily are efficient in the following circumstances:

- The volume of transactions is relatively high.
- The transactions are recurring and relatively uniform within the transaction class.
- The transactions are not complex.
- The transactions are routinely processed in information systems with well-designed control activities.
- The entity's control environment, monitoring, and risk assessment processes are conducive to effective controls.

In those circumstances, it may be efficient to assess the risk of material misstatement with an expectation of the operating effectiveness of controls, that is, to assess control risk at less than high and test controls. Another circumstance that may lend itself to efficient tests of controls is the situation where key controls for preventing or detecting and correcting material misstatements consist primarily of high level monitoring or other entity-level controls that are easy to test.

In some cases, the auditor may determine that it is both more effective and more efficient to test controls than to perform extensive substantive procedures. In situations such as these, the auditor may determine that tests of controls would permit a substantial modification in substantive procedures, such as a change in the nature or extent of procedures, and would result in a more effective, as well as more efficient, audit.

When considering whether tests of controls would be efficient, the auditor evaluates the following cost/benefit factors:

- *Impact on Substantive Procedures.* By performing tests of the operating effectiveness of controls, the auditor may be able to alter the nature, timing, or extent of substantive procedures. For example, when the auditor uses sampling in planned substantive procedures, sample sizes will generally be lower when the auditor tests the operating effectiveness of controls. The lower level of assessed risk allows the auditor to reduce the confidence levels required in sampling applications.

- *Relevant Costs.* When determining a preliminary audit strategy, some auditors may mistakenly believe that a decision to not test the operating effectiveness of controls will eliminate some or much of the need to obtain a sufficient understanding of internal control. The auditor is required to obtain an understanding that includes an evaluation of the design of controls and determination about whether they have been implemented. Therefore, the relevant cost in an efficiency decision is only the incremental cost of testing the operating effectiveness of controls.

- *The Need to Test Indirect or Complementary Controls.* When considering the cost of testing controls, auditors should not lose sight of the need to obtain audit evidence about information that allows the effective operation of those controls. For example, if the completeness of documents is tested by inspection of a computer-generated report on the sequence of documents, the auditor will need to understand and test the relevant IT controls. Furthermore, when testing automated application controls, the auditor would need to consider the effective functioning of general controls.

- *Whether Controls Have Changed during the Audit Period.* During the audit period, an entity may redesign its controls or implement new controls. SAS No. 110 (AU 318.26) indicates:

  > If substantially different controls were used at different times during the period under audit, the auditor should consider each separately.

  The need to design and perform control tests on controls that changed during the period may have a significant impact on efficiency considerations. For example, the same test may not be effective both before and after the control change and, therefore, two or more different tests may be needed.

- *The Impact on Future Audits.* An auditor may be able to use audit evidence from tests of controls over a three year period, subject to certain conditions. Therefore, auditors may not want to isolate their cost-benefit analysis to only the current audit in continuing engagements where controls are not expected to change significantly from year to year. In those cases, the benefits from reduced substantive procedures may be realized for three years if controls can be rotationally tested.

- *Whether Assertions Can Be Tested Using Computer-assisted Audit Techniques.* Some auditors believe that when using computer-assisted audit techniques (CAATs), some account balances or transaction classes can be audited 100% more efficiently than by testing controls. However, where the information used to perform substantive procedures is produced by the entity's information system, the auditor should obtain evidence about the information's accuracy and completeness. Also, the auditor's use of CAATs does not eliminate the need to have an understanding of the controls over the system, including IT general controls and particularly the portion of the system that generated the copy of the file being tested by CAATs.

- *Client Expectations.* An auditor might test controls for reasons other than audit purposes. For instance, the client may specifically engage the auditor to test controls. Or, the client may have expectations that controls will be tested, and the auditor may decide to test only to meet those expectations as a client service and to provide added value. In such cases, the auditor tests controls even though the auditor would not otherwise have done so. For example, even though the cash collected from the permit department is immaterial to the financial statements, the client's governing body may expect the auditor to perform certain tests of controls related to collections. In such cases, the auditor may test controls that would not have otherwise been required to be tested.

Efficiency opportunities when performing tests of controls are further discussed later in this lesson.

Considerations When Performing a Single Audit. In a Single Audit, there are additional considerations when deciding whether to test controls. Section 500(c)(2) of OMB Circular A-133 requires the auditor to:

- plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and

- *perform testing* of internal control as planned (emphasis added). . .

- report on internal control over compliance *describing the scope of the testing of internal control and the results of the tests* . . . (emphasis added)

Using Single Audit Testwork to Reduce Testwork in the Financial Statement Audit. The auditor should determine the control testwork necessary for performing the Single Audit and then consider how that testwork might contribute to the financial statement audit. For example, a governmental unit may have one internal control process for handling payroll transactions. If the auditor tests the controls over payroll as part of the Single Audit, the auditor should consider that testwork when determining what additional tests of controls or other substantive procedures are necessary as part of the financial statement audit. The auditor may also choose to design tests of controls so that transactions from the governmental unit's nonfederal program activities are selected for testing at the same time as the federal program transactions. As long as the Single Audit requirements are met, this method of testing may allow the auditor to be more efficient and maximize the audit evidence obtained from the tests of controls. The auditor should always take credit for all testwork performed when determining additional procedures to perform.

Substantive Procedures Alone Do Not Provide Sufficient Audit Evidence

SAS No. 109 (AU 314.117) indicates that auditors should identify those 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, auditors should identify risks for which substantive procedures alone are not effective. Those risks often occur in audit areas in which there is highly automated processing with little or no manual intervention. Therefore, due to the importance of effective controls over accuracy and completeness in processing, it may not be practical, or even possible, to perform only substantive procedures without testing controls.

Examples of When Testing Controls May Be Necessary. The auditor may decide that it is necessary to test controls when an entity's accounting data and corroborating evidence are available only in electronic form that is not retrievable after a period of time (for example, when a significant amount of information supporting one or more financial statement assertions is electronically initiated, authorized, recorded, processed, or reported and related audit evidence exists only in electronic form). In such cases, the appropriateness and sufficiency of the audit evidence usually depend on the effectiveness of controls over their accuracy and completeness, and tests of the controls may be necessary. For example, it may be necessary to perform tests of controls when an entity uses the computer to initiate orders for products based on predetermined rules and pays the related payables based on electronic information in transactions concerning receipt of goods, and no other documentation of orders or receipts is produced or maintained.

Some auditors believe that in audits of governmental units, the risk of theft of cash is such that it is usually necessary to test controls over cash receipts and disbursements. For example, with respect to revenues received primarily in cash (such as fees for activities of some enterprise funds) it may be difficult to limit audit risk for the completeness assertion to an appropriate level without an assessed level of control risk at less than high. If auditors believe that there is a significant risk of error or theft of cash through cash disbursements, they may test high-level controls, such as the reconciliation routine, segregation of duties, and management oversight of the process. They may also test a selection of disbursements for those controls designed to prevent or detect theft (such as evidence of an invoice and evidence of proper authorizations), as well as for proper account coding. If the tests of transactions show the controls to be operating effectively, the auditor may be able to assess control risk at less than high and reduce the extent of vouching in other audit areas. For example, an auditor might assess control risk for prepaid expenses at less than high based on an adequate control environment and tests showing effective controls over disbursements.

Specialized Considerations for Governmental Units. For audits of governmental units, there are additional considerations when deciding whether to test controls. A government, especially a small one, may also have the following characteristics that increase the assessed level of control risk:

- An elected governing body that may be political in nature and unfamiliar with internal control considerations.
- Part-time or relatively unknowledgeable administrators and employees who are not aware of the importance of adhering to specified procedures or who are inclined to take "shortcuts."
- Accounting personnel with minimal education or experience in accounting.
- Too few employees to permit an adequate segregation of duties.

DETERMINING WHICH CONTROLS TO TEST

The most efficient and effective approach to deciding which controls to test is to take a top-down approach. Begin with the opinion unit financial statements and identify the significant accounts and disclosures. Then identify the significant transaction classes and processes that result in those accounts and disclosures. Within those transaction classes and processes, identify the controls that individually, or in combination with other controls, prevent or detect and correct material misstatements in the relevant assertions related to identified risks. This approach should result in emphasizing the areas in which material misstatements are most likely to occur.

It is also efficient and effective to consider entity-wide level controls before testing control activities. One reason to take this approach is that if the controls at the top level are poor, it creates an environment that is not conducive to effective controls, and even well-designed and implemented control activities might not be effective. In that case, testing control activities may not be productive. Additionally, some controls at the top might operate at a direct and detailed enough level to reduce the risk of material misstatement at the relevant assertion level. If that is the case, it might be easier and more efficient to test the entity-wide level controls than control activities, or testing those controls might at least permit a reduction in the extent of testing control activities.

The remainder of this section discusses the following aspects of deciding which controls to test:

- Test only those controls that are suitably designed and implemented.
- Test controls within significant processes, but do not test process steps independently of those controls.
- Test controls relevant to the risks of material misstatement of relevant assertions.
- Test the key controls that are relevant to the identified risks.
- Consider the need to test indirect or complementary controls that support the effective operation of control activities being tested.
- If several controls yield equivalent evidence, test the easy-to-test controls.
- Test controls for the assertions relevant to major program compliance requirements.

Improperly Designed Controls or Controls Not Implemented

SAS No. 110 (AU 318.25) emphasizes that only effectively designed controls should be tested for operating effectiveness. Specifically, it states:

> Tests of operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion.

There is no benefit to testing the operating effectiveness of a control that is inappropriately designed to prevent or detect a material misstatement in a relevant assertion. Even if an improperly designed control could be found to be consistently applied and operating as designed throughout the year, no amount of testing will transform it into a control that is capable of preventing or detecting misstatements.

Also, there is no benefit in testing a control that has not been properly implemented. For example, an auditor might conclude that the documentation of controls in the client's accounting procedures manual indicates that controls are effectively designed to address risks of material misstatement and satisfy relevant control objectives. However, when determining whether the controls are implemented by performing various risk assessment procedures, the auditor finds that the controls, as designed, are not properly communicated or followed. In that case, tests of those controls would not be performed.

Tests of Controls versus Processes

When designing and performing tests of controls, auditors should ensure that the item being tested is, in fact, a control and not a processing step. A process is best described by example. A process would be the coding of an invoice by the accounts payable clerk and the subsequent input to the payable system. A control, however, addresses the risk of what could go wrong in the process, and by doing so it either prevents or detects and corrects misstatements that could occur as a result of processing the transaction. In the accounts payable area, examples of controls include supervisory review of the amounts input and account coding, the use of programmed restrictions in the accounts payable system that limit which accounts are eligible for coding, or programmed edit routines that detect input amounts that do not agree to underlying purchase orders. While this concern is more appropriately addressed when evaluating the design and implementation of controls, auditors should take care that their control tests do not incorporate a process without a corresponding control.

Controls Relevant to Identified Risks

The focus of control testing should be on controls that are relevant to risks the auditor has identified (that is, the risk that the assertion is misstated). The misstatement could be an overstatement due to theft, improper valuation, or an unreasonable estimate, understatement due to unrecorded transactions, etc. In many audits of governmental units, the auditor might be able to test only one or two selected controls relating to the risk of concern for a specific assertion for an account. The auditor does not always have to test all the control activities relating to an assertion to assess control risk at less than high. For fraud risks or other significant risks, as well as risks for which substantive procedures alone are not adequate, the auditor should obtain an understanding of the design and implementation of the related controls, which can serve as a basis for determining which controls to test.

Key Controls

The auditor should focus on those controls that are key to preventing or detecting material misstatements in the financial statements. Key controls often include actions of supervisors and senior management and may include documentation of supervision, budgeting, reporting, review, etc., that can be easily tested by inquiry, observation, and inspection of reports and documents. Not only are such controls easier and more efficient to test (such as by reviewing the client's investigation and variance reports) than are detailed tests of transactions, but the tests may provide more assurance about the controls than tests of transactions. For example, management may prepare budgets, periodically compare them to actual results, and investigate significant variations in a timely manner, or management may compare financial statement results to relevant operational data, such as comparing units of service provided to hours charged. Reports of the variations, investigative actions, explanations of the variations resulting from the investigations, and corrective actions taken may provide evidence of the effective operation of the control activity. Such a control may be a key control with respect to the reasonableness of revenues or expenses.

Control Activities and Complementary Controls

When considering which controls to test for an audit area, the auditor generally focuses on control activities. Paragraph 6.09 of the AICPA Risk Assessment Audit Guide indicates:

> When designing tests of controls, typically you will focus first on testing control activities, since the control activities component of internal control is the one most directly related to the assertion. For example, physically counting goods that have been received and comparing the quantity and description to the vendor's packing slip is directly related to both the existence and valuation of inventory.

In addition to the direct test of a control activity, SAS No. 110 (AU 318.31) indicates the following:

> In designing tests of controls, the auditor should consider the need to obtain audit evidence supporting the effective operation of controls directly related to the relevant assertion as well as indirect controls on which these controls depend.

The AICPA Risk Assessment Audit Guide refers to these indirect controls as *complementary controls*.

Indirect or complementary controls may include:

- Controls over the accuracy and completeness of information used in the performance of the direct control.
- IT general controls.
- Segregation of duties.
- The control environment.

Determining whether to test complementary controls and the nature and extent of those tests requires judgment. Some of the factors that might be considered when making such decisions are:

- *Significance of the Complementary Control to the Effective Functioning of the Direct Control.* The significance of a complementary control to the effective functioning of the related direct control may vary greatly depending on the situation. Obviously, as the degree of significance increases, the need for audit evidence about the complementary control also increases. In some situations, such as for IT application and general controls, the conclusion reached on the operating effectiveness of the direct (application) control may be based primarily on the audit evidence related to the complementary (general) control.
- *Degree of Assurance Required from Tests of Operating Effectiveness.* If the auditor requires a greater degree of reliability or assurance from the tests of operating effectiveness, the degree of audit evidence needed about complementary controls should also increase.
- *Evidence Obtained through Risk Assessment Procedures.* When the auditor performs risk assessment procedures to understand the direct control, evidence about the operating effectiveness of complementary controls might also be obtained. In certain situations, the auditor might possibly determine that sufficient evidence about the complementary controls has been obtained from risk assessment procedures alone after considering the factors previously discussed.

When evaluating whether to test a control activity from an efficiency perspective, the auditor should consider the additional costs of testing complementary controls to determine if testing is cost effective. For example, the auditor determines that the client's cash reconciliation is a key control that, if operating effectively, will allow a modification in the nature of substantive procedures for cash. The reconciliation, research, and resolution of identified issues is the key control, but the effective operation of the control is also dependent on proper segregation of duties. If the reconciliation was performed by individuals that have the ability to post cash receipts and disbursement activity to the general ledger, the effectiveness of the control may be compromised. Therefore, as part of testing the operation of the control, the auditor also would want to ensure that proper segregation of duties was maintained for individuals performing the control.

Easy-to-test Controls

Some controls may be easier to test than others and yet yield equivalent evidence to support a risk assessment. Naturally, if there is a choice, the auditor should test the control that is easier to test, considering the availability of evidence. The auditor should not, however, test controls that are not relevant to the audit just because those controls are easier to test.

SELF-STUDY QUIZ

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

19. Government Auditing Standards require the auditor to communicate to the client certain internal control matters related to the nature of the work planned and the level of assurance provided on internal control. Which of the following are recommended for that communication?

    a. Be discussed with management by the audit partner, be included in the client representation letter, and made after all fieldwork is completed.

    b. Be in writing, made during planning, and communicated to management.

    c. Be made before accepting the engagement, provide the communication to the controller, and communicate the level of assurance on internal control.

20. Archie Auditor has been engaged in an audit to test controls. Should Archie first test the operating effectiveness of controls or should he obtain evidence of implementation?

    a. Operating effectiveness.

    b. Implementation.

21. According to SAS No. 110, in which of the following situations should tests of controls be performed?

    a. When substantive procedures themselves are effective in providing sufficient appropriate evidence at the relevant assertion level.

    b. When an expectation that controls are operating effectively is included in the auditor's assessed risk of material misstatement.

22. An auditor considers if tests of control in an audit of a governmental entity are appropriate when performed in the perspective of which of the following?

    a. Financial statement reconciliations.

    b. Opinion units.

23. Which of the following statements regarding an auditor's expectation of operating effectiveness is most accurate?

    a. Auditors should obtain audit evidence supporting his or her expectation about the assertion being tested before assessing risk assessment.

    b. Auditors should have an expectation of operating effectiveness when inherent risk is high.

    c. Auditors should test controls even when unable to recognize controls in place that would prevent or detect and correct material misstatements in particular relevant assertions.

24. Which of the following decisions should regarding testing controls typically should be made based on the preliminary assessment of control risk?

    a. Entity-wide.

    b. Low materiality.

c. Assertion-by-assertion.

d. Global.

25. Tests of controls would be more efficient than substantive procedures from a cost/benefit standpoint when which of the following has occurred?

    a. Application controls are automated.

    b. Account balances can be tested using computer-assisted audit techniques (CAATs).

    c. Audit evidence from tests of controls may be used over a three-year period.

    d. New controls have been implemented during the audit period.

26. Which of the following types of controls is considered a direct control?

    a. Key controls.

    b. IT general controls.

    c. Segregation of duties.

27. Evidence regarding the operating effectiveness of controls is usually obtained from which of the following?

    a. Substantive procedures.

    b. Tests of controls.

    c. Pre-engagement activities.

    d. Prior audits.

28. The AICPA Risk Assessment Audit Guide indicates complementary (indirect) controls may include which of the following?

    a. IT specific controls.

    b. Combining of duties.

    c. The control environment.

SELF-STUDY ANSWERS

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

19. Government Auditing Standards require the auditor to communicate to the client certain internal control matters related to the nature of the work planned and the level of assurance provided on internal control. Which of the following are recommended for that communication? **(Page 53)**

    a. Be discussed with management by the audit partner, be included in the client representation letter, and made after all fieldwork is completed. [This answer is incorrect. Although discussing internal control matters related to the nature of the work planned and the level of assurance provided on internal control would be helpful, it is not a requirement per Paragraph 4.06 of the Yellow Book. Also, including this communication in the client representation letter and having the communication completed after all fieldwork is concluded, is not required by the Yellow Book.]

    b. Be in writing, made during planning, and communicated to management. [This answer is correct. Paragraph 4.06 of the Yellow Book requires auditors to communicate the nature of the planned work and level of assurance to be provided on internal control over financial reporting. This communication should be (a) in writing, (b) made during audit planning, and (c) made to management, those charged with governance, and the individuals contracting for or requesting the audit. Government Auditing Standards also require auditors to issue a written report on internal control over financial reporting.]

    c. Be made before accepting the engagement, provide the communication to the controller, and communicate the level of assurance on internal control. [This answer is incorrect. According to Paragraph 4.06 of the Yellow Book, these tasks are not required when communicating the nature of the planned work and the level of assurance provided on internal control over financial reporting.]

20. Archie Auditor has been engaged in an audit to test controls. Should Archie first test the operating effectiveness of controls or should he obtain evidence of implementation? **(Page 55)**

    a. Operating effectiveness. [This answer is incorrect. Operating effectiveness relates to how and by whom controls are applied and the means by which, and consistency with which, the controls are applied.]

    b. Implementation. [This answer is correct. According to SAS No. 110, Implementation means that controls exist and are being used.]

21. According to SAS No. 110, in which of the following situations should tests of controls be performed? **(Page 56)**

    a. When substantive procedures themselves are effective in providing sufficient appropriate evidence at the relevant assertion level. [This answer is incorrect. According to SAS No. 110, tests of controls should be performed when substantive procedures alone are *not* effective and do *not* provide sufficient appropriate evidence at the relevant assertion level.]

    b. When an expectation that controls are operating effectively is included in the auditor's assessed risk of material misstatement. [This answer is correct. Tests of controls should be performed when the auditor's assessed risk of material misstatement includes an expectation that controls are operating effectively per SAS No. 110, to obtain evidence to support the operating effectiveness of the controls.]

22. An auditor considers if tests of control in an audit of a governmental entity are appropriate when performed in the perspective of which of the following? **(Page 57)**

    a. Financial statement reconciliations. [This answer is incorrect. Most governments maintain their primary accounting records on the basis of individual funds and separately develop the additional information needed for the government-wide financial statements. While much of that additional information is presented in reconciliations between the fund financial statements and the government-wide financial statements, some additional information is not displayed in the reconciliations. Thus, the auditor's consideration of whether tests of controls are appropriate in the audit of a governmental entity is *not* performed in the perspective of financial statement reconciliations per SAS No. 110.]

b. Opinion units. [This answer is correct. The auditor's consideration of whether tests of controls are appropriate in the audit of a governmental entity is performed in the context of opinion units. If the internal control for a transaction cycle is handled by the same system regardless of where the transactions and balances are reported in the financial statements, the auditor's consideration of internal control and assessment of control risk for that system would apply equally to all affected opinion units, even if transactions and balances reported in an individual opinion unit are not included in a test of controls.]

23. Which of the following statements regarding an auditor's expectation of operating effectiveness is most accurate? **(Page 57)**

a. Auditors should obtain audit evidence supporting his or her expectation about the assertion being tested before assessing risk assessment. [This answer is correct. To reduce the control risk assessment, the auditor should obtain audit evidence supporting his or her expectation that such controls are operating effectively. Therefore, the audit approach consists of a combination of tests of controls and substantive procedures that provide sufficient audit evidence about the assertion being tested.]

b. Auditors should have an expectation of operating effectiveness when inherent risk is high. [This answer is incorrect. Best practices indicate that an expectation of operating effectiveness typically means that the auditor's planned control risk assessment is less than "high." In some cases, the combined risk of material misstatement can be assessed at a moderate or low level even though control risk is assessed as high. That might be the case, for example, when inherent risk is low or moderate. In that case, there is no expectation of operating effectiveness and, thus, no tests of controls would be performed.]

c. Auditors should test controls even when unable to recognize controls in place that would prevent or detect and correct material misstatements in particular relevant assertions. [This answer is incorrect. There may be instances when the auditor is unable to identify controls in place that would prevent or detect and correct material misstatements in specific relevant assertions. In such cases, which may occur in very small entities, testing controls would not be a consideration. However, SAS No. states that in cases involving very small entities where the auditor has not identified many control activities, the auditor should consider if in the absence of controls it is possible to obtain sufficient appropriate audit evidence.]

24. Which of the following decisions should regarding testing controls typically should be made based on the preliminary assessment of control risk? **(Page 59)**

a. Entity-wide. [This answer is incorrect. It is efficient and effective to consider entity-wide level controls before testing control activities. One reason to take this approach is that if the controls at the top level are poor, it creates an environment that is not conducive to effective controls, and even well-designed and implemented control activities might not be effective.]

b. Low materiality. [This answer is incorrect. For audits performed under Government Auditing Standards, the Yellow Book, at Paragraph 4.26, indicates that it might be appropriate to use lower materiality levels in Yellow Book audits due to the public accountability of governmental entities and entities receiving government funding, legal and regulatory requirements, and the visibility and sensitivity of government programs.]

c. Assertion-by-assertion. [This answer is correct. Decisions about testing controls should normally be made on an assertion-by-assertion level based on the preliminary assessment of control risk, because while obtaining an understanding of internal control, controls may be identified that prevent or detect and correct material misstatements for relevant assertions.]

d. Global. [This answer is incorrect. Best practices indicate that efficiency decisions should not be considered at a global level for the entity as a whole.]

25. Tests of controls would be more efficient than substantive procedures from a cost/benefit standpoint when which of the following has occurred? **(Page 60)**

a. Application controls are automated. [This answer is incorrect. Included in the cost of testing controls is the need to obtain audit evidence about information that allows the effective operation of those controls, as well as the need to consider the effective functioning of general controls.]

b. Account balances can be tested using computer-assisted audit techniques (CAATs). [This answer is incorrect. When the information used to perform the substantive procedures is produced by the entity's information system, the auditor should acquire evidence concerning the information's accuracy and completeness. The auditor must also obtain an understanding of the controls over the system, including IT general controls and particularly the portion of the system that generated the copy of the file being tested by CAATs.]

c. Audit evidence from tests of controls may be used over a three-year period. [This answer is correct. An auditor may be able to use audit evidence from tests of controls over a three-year period if certain conditions are met. As a result, auditors may choose not to isolate their cost-benefit analysis to only the current audit in continuing engagements where controls are not expected to change significantly from year to year.]

d. New controls have been implemented during the audit period. [This answer is incorrect. A significant impact to efficiency considerations may result from the need to design and perform control tests on controls that changed during the period. As a result, the same test may not be effective both before and after the control change, and may require two or more different tests and result in lower efficiency.]

26. Which of the following types of controls is considered a direct control? **(Page 63)**

a. Key controls. [This answer is correct. Key controls include actions of supervisors and senior management and may include documentation of supervision, budgeting, reporting, review, etc., that can be easily tested by inquiry, observation, and inspection of reports and documents. Not only are such controls easier and more efficient to test, but the tests may provide more assurance about the controls.]

b. IT general controls. [This answer is incorrect. This is an example of an indirect control. Documentation of budgeting is a direct control but its accuracy is dependent on complimentary IT controls.]

c. Segregation of duties. [This answer is incorrect. According to the AICPA Risk Assessment Audit Guide, segregation of duties is considered an indirect or complementary control.]

27. Evidence regarding the operating effectiveness of controls is usually obtained from which of the following? **(Page 73)**

a. Substantive procedures. [This answer is incorrect. Substantive procedures may provide additional evidence that either supports the auditor's conclusion about the operating effectiveness of controls or creates the need to reevaluate the prior assessment of control risk but is not how evidence about the operating effectiveness of controls is usually obtained.]

b. Tests of controls. [This answer is correct. Evidence about the operating effectiveness of controls is usually obtained through tests of controls because tests of controls are generally easier and more efficient than detailed tests of transactions. Evidence may be derived from a variety of other sources however.]

c. Pre-engagement activities. [This answer is incorrect. Procedures and conclusions reached regarding client acceptance or continuance may provide evidence regarding management's ethical values, operating philosophy, integrity, and competence. However, pre-engagement activities are not the way in which evidence about the operating effectiveness of controls is usually obtained.]

d. Prior audits. [This answer is incorrect. Best practices indicate that prior audits may yield evidence regarding operating effectiveness but they are not the principal means by which evidence of the operating effectiveness of controls is normally obtained.]

28. The AICPA Risk Assessment Audit Guide indicates complementary (indirect) controls may include which of the following? **(Page 64)**

a. IT specific controls. [This answer is incorrect. According to the AICPA Risk Assessment Audit Guide, indirect or complementary controls may include IT *general* controls, not IT specific controls.]

b. Combining of duties. [This answer is incorrect. Complementary controls may include the *segregation* of duties, not the combining of duties per the AICPA Risk Assessment Audit Guide.]

c. The control environment. [This answer is correct. One of several controls considered as indirect or complementary controls by the AICPA Risk Assessment Audit Guide is the control environment because complementary controls can be used as reinforcement to other control mechanisms.]

CHOOSING APPROPRIATE PROCEDURES

Tests of controls are further audit procedures that are performed with the objective of obtaining assurance about the operating effectiveness of controls. Auditors may perform one or a combination of tests to obtain the level of assurance needed to support the assessed level of control risk. When selecting control tests, auditors consider the cumulative evidence about operating effectiveness that is obtained from various sources.

This section discusses the nature or types of tests of controls. The time frame for testing controls, the extent of such tests, efficiency opportunities when testing controls, and other matters related to performing tests of controls are discussed later in this lesson. Tests of IT related controls are also discussed later in this lesson.

While evidence about the operating effectiveness of controls is generally obtained through tests of controls, the auditor should be mindful that evidence about operating effectiveness may be derived from a variety of sources:

- *Pre-engagement Activities*. Procedures and conclusions reached regarding client acceptance or continuance may provide evidence regarding management's ethical values, operating philosophy, integrity, and competence.

- *The Understanding of Controls Obtained as Part of the Risk Assessment Process.* Many of the procedures commonly used in the risk assessment process to gain an understanding of internal control also may provide evidence about the controls' operating effectiveness.

- *Compliance Audits.* While the auditor's consideration of internal control over compliance is for the purpose of expressing an opinion on compliance and not on the effectiveness of internal control over compliance, many of those procedures used to gain an understanding of internal control also may provide evidence about the controls' operating effectiveness.

- *Prior Audits.* SAS No. 110 (AU 318) explicitly recognizes that the auditor may be able to use audit evidence about the operating effectiveness of controls obtained in prior audits.

- *Type 2 SAS No. 70 Reports.* A service auditor may apply tests of controls at a service organization and report on whether specified policies and procedures are operating with sufficient effectiveness to achieve specified control objectives. This type of report, also known as a "Type 2 SAS No. 70 report," may be helpful in determining whether controls have been implemented and assessing control risk at either a low or moderate level when relevant controls are applied only at the service organization.

Substantive procedures may provide additional evidence that is consistent with the auditor's conclusion about the operating effectiveness of controls or that creates the need to reevaluate the prior assessment of control risk. However, auditors should be aware that a lack of misstatements as a result of substantive procedures does not provide audit evidence about the operating effectiveness of controls. On the other hand, SAS No. 110 (AU 318.34) indicates that a material misstatement detected through the performance of substantive procedures "that was not identified by the entity is evidence of a deficiency in internal control and may be a significant deficiency or a material weakness in internal control."

Understanding the potential sources of evidence is important to the auditor when designing tests of controls, considering the extent and timing of those tests, and evaluating the effect on the control risk assessment. The audit evidence provided from various sources should be considered in a cumulative manner when deciding whether sufficient evidence has been obtained to support the auditor's evaluation of operating effectiveness and the final assessment of control risk. In choosing procedures to test a control, consider the degree of assurance provided by the procedure in relation to the degree needed. If there is a choice, choose the procedure that is most efficient in providing the needed degree of assurance.

Nature and Types of Tests of Controls

Tests of controls (either manual or automated) ordinarily include procedures such as the following:

- Inquiries of appropriate entity personnel.

- Observation of the application of the control.
- Inspection of documents, reports, or electronic files indicating performance of the control.
- Walkthroughs.
- Reviews of reconciliations and similar bookkeeping routines.
- Reperformance of the application of the control.

The information and evidence typically sought from tests of controls include the following:

- What the control activity is.
- Who performs it, including the person's name and job title.
- How it is performed.
- The consistency with which it was performed during the period.
- What reports, files, or other documents are used in performing the control.
- What reports, files, or other documents, if any, are produced as evidence of the performance of the control.
- What action is taken if the control activity reveals an error, discrepancy, or unusual item.
- How supervisory and managerial personnel satisfy themselves that the control is operating as planned to prevent or detect errors.

The auditor often obtains evidence about the operating effectiveness of controls by performing a combination of the procedures listed above, as well as from the understanding of controls and prior audits. (Rotating tests of controls over a three year cycle is discussed later in this lesson.) The procedures and sources of information complement and supplement one another. For example, an auditor may inquire about the existence and nature of a control activity, have the person who performs it demonstrate or walk through the steps involved, and inspect the documents or electronic files used or reports produced. In this example, the auditor would have used inquiry, observation, inspection, and a walkthrough. These procedures would not only provide the auditor with an understanding of the control activity, but would also constitute a test of the control.

According to SAS No. 110 (AU 318.29), inquiry alone is not sufficient to obtain reasonable assurance of operating effectiveness. Thus, the auditor should perform other procedures in combination with inquiry. According to the SAS, however, "those controls subject to testing by performing inquiry combined with inspection or reperformance ordinarily provide more assurance than those controls for which audit evidence consists solely of inquiry and observation." For example, the auditor might inquire about and observe the procedures for opening mail and processing cash receipts. To obtain greater assurance, the auditor could supplement those inquiries and observations with procedures such as inspecting documents (for example, prelists of cash receipts) and, possibly, reperformance procedures (for example, reperforming the comparison of amounts on prelists to accounting records and bank deposits).

The nature of the control that is being tested will generally direct the type of procedure necessary to obtain audit evidence about operating effectiveness. For example, a control in which a manager reviews the clerical accuracy of the coding of invoices over $1,000 may be evidenced by the manager's initials on the invoice. The nature of this control would generally dictate the auditor's procedures to be inspection of the invoice for documentation of the manager's initials combined with reperformance of the control activity (that is, a check of the clerical accuracy). Efficiency is also a consideration when selecting audit procedures. If there is a choice, choose the procedure that is most efficient in providing the needed degree of assurance. The following paragraphs discuss the procedures commonly used to test controls.

Inquiry and Observation. Inquiry and observation are often used in the general planning and risk assessment phase of the audit to obtain an understanding about controls and whether they have been implemented. Also, while making inquiries and observations for that purpose, the auditor may also gain evidence about the controls' operating effectiveness. Inquiry and observation are typically used to test controls that do not produce documentary evidence of performance, such as separation of duties, controls over access to assets and records, certain control environment factors, or some control activities performed by a computer. Inquiry and observation often complement or supplement each other. For example, the auditor might inquire about the existence of a particular control activity and then observe the activity being performed to determine that it is in fact in operation and perhaps also to assess its effectiveness. Similarly, observation should often be supplemented by inquiry since an observation is only pertinent at the point in time at which it is made.

Inspection of Documents, Reports, or Electronic Files. This procedure includes inspection of source documents (such as invoices and receiving reports), log books (such as receiving logs), reports (such as internal auditors' reports and exception reports), accounting procedures manuals, or (for operating effectiveness) electronic files. Documents are inspected for an indication that the control activity was performed (for example, initials of the person who approved a transaction or a clerk's checkmark indicating that a total was footed or an extension checked). Reports, which may include internally produced financial or operational reports or externally produced reports of financial institutions, regulatory agencies, service organization auditors, etc., are reviewed for description of the activity or investigation performed, the resulting findings, and the client's response to problems detected.

Audit sampling is sometimes used in tests of controls that involve inspection of documents. However, tests of controls involving document inspection do not necessarily require sampling, for example, inspection of documents in conjunction with inquiries and observations, walkthroughs, or reviews of reconciliations.

Walkthroughs. Walkthroughs are commonly used in gaining an understanding (or further understanding) of controls. A walkthrough can also serve as a test of controls and in some cases, along with other tests of controls, can provide a valid basis for assessing control risk at less than high. However, this approach generally by itself does not provide a sufficient basis for assessing control risk as low.

Reviews of Reconciliations and Similar Bookkeeping Routines. Reviews of reconciliations and similar bookkeeping routines can be very efficient tests of controls. The auditor's approach to testing these routines is generally as follows:

- Inspect evidence that the routine was performed throughout the period (for example, reports of unmatched items or written bank reconciliations).

- Inspect examples of the routine having been performed.

- Investigate the resolution of significant misstatements or exceptions disclosed by the routine, or investigate a few if none are significant.

Reperformance of the Control Activity. Examples of reperformance tests of controls include recomputing extensions and totals on vendor's invoices, or recomputing gross pay. Reperformance tests are commonly performed along with inspection of documents. For example, the auditor may test the clerical accuracy of vendors' invoices and inspect supporting documents for evidence of proper approval. Audit sampling is sometimes used in tests of controls that involve reperformance of control activities applied to documented transactions. Sampling in tests of controls is discussed later in this lesson.

An advantage of reperformance is that it usually provides substantive audit evidence about the transaction as well as about the control activity (that is, it is a dual-purpose test). For example, the auditor will obtain evidence that the transaction is recorded in the proper account at the proper amount as well as that it was properly approved.

Reperformance tests can be very time-consuming. Thus, reperformance tests should be avoided to the extent possible. However, such tests may be necessary (instead of or in addition to other tests such as inquiry or observation) if the control is particularly significant or if controls are tested when the control environment is not strong.

Specialized Considerations for Governmental Units

Exhibit 2-1 gives examples of common tests of control activities in governmental audits. Auditors may also wish to perform tests relating to the control environment, risk assessment, information and communication, and monitoring when controls in those components can be relied on to modify substantive procedures.

Exhibit 2-1

Examples of Common Tests of Controls in Governmental Audits by Audit Area

1. **BUDGET**

   - Review minutes of meetings adopting the annual budget and approving amendments.
   - Review workpapers supporting the annual budget.
   - Inquire of government officials concerning the use of interim budget-to-actual comparisons.
   - Inspect explanation of budget variances and evidence of corrective action taken.
   - Review reconciliations of recorded outstanding encumbrances to actual encumbrances outstanding.

2. **CASH**

   - Observe handling of collections in the mail room and compare prelists of mail collections (or lockbox report) to deposits on bank statements, noting that those who handle collections are not involved in cash recordkeeping.
   - Select a sample of mail collections and trace remittance advices and deposit slip detail to recorded cash receipts and, if applicable, to posting to receivables detail, noting that those who handle collections are not involved in recordkeeping for cash or receivables.
   - Observe currency collection procedures at selected locations, noting appropriate separation of duties; make test counts of cash and reconcile to cash register tape or other control total.
   - Select a sample of noncash credits to receivables, review for compliance with approval policies, and investigate significant or unusual items.
   - Select a sample of cash disbursements, review for compliance with documentation and approval policies, clerical accuracy, authorized signature, proper endorsement, agreement of details (check number, payee, etc.), reasonableness of period from issuance to cancellation, and appropriateness of treatment in bank reconciliation.
   - Foot the disbursements journal for selected portions of the period and trace to cash records and bank statements, noting evidence of posting approvals.
   - Test one month's bank reconciliations by tracing to cutoff bank statements; inspect reconciliations for other months and investigate significant and unusual items; and review for evidence of supervisory review and approval.

3. **PETTY CASH**

   - Count petty cash fund in the presence of custodian and review contents for indications of compliance with controls.
   - Select some petty cash reimbursements as part of the sample of expenditures (concurrently with cash disbursements and purchases of goods and services) and review for compliance with reimbursement policies and procedures.

4. **INVESTMENTS**

- Select a sample of investment transactions during the period and examine for indications of compliance with controls and investment policy.

- Read minutes of meetings authorizing investment transactions and compare to recorded activity.

- Inspect interim reports on investment yield and consider investigations made, if any, of significant fluctuations.

5. **REVENUE AND RECEIVABLES—GOVERNMENTAL FUNDS**

Property Taxes

- Select a sample of properties from an independent source, trace to tax rolls, check tax status, and inspect approvals for exempt or other special status.

- Select a sample of changes to tax rolls and review for accuracy and indications of compliance with controls.

- Select a sample of tax bills and review for accuracy and indications of compliance with controls.

- Inspect reconciliations of tax roll detail to control account and total assessed valuation and review for supervisory review and approval.

Licenses, Fees, or Permits

- Select a sample of applications for licenses, fees, or permits (concurrently with cash receipts) and review for accuracy and indications of compliance with controls.

- Observe procedures for issuing forms and controlling unused forms.

Fines, Performance Bonds, and Court Fees

- Observe activities of court cashier.

- Observe procedures for handling issued traffic tickets.

- Inspect reconciliation of bonds to court journals, noting appropriate separation of duties and supervisory reviews and approvals.

- Review procedure for numerical control of fines and bond forfeitures.

- Inquire of official responsible for monitoring delinquent receivables and inspect agings of receivables and follow up on collections for conformity with policies and procedures.

Special Assessments

- Observe separation of functions of computing, billing, and collecting.

- Select a sample of special assessment bills and review for accuracy and indications of compliance with controls; trace through accounting records.

- Select a sample of special assessment expenditures and review for accuracy and indications of compliance with controls.

- Inspect reconciliations of special assessment receivable detail with control account and review for supervisory review and approval.

- Inquire of officials responsible for monitoring special assessment projects and reviewing and approving closings.

Interfund Transfers

- Select a sample of interfund transfers, and review for accuracy and indications of compliance with controls.

- Inspect reconciliations of interfund balances and review for evidence of supervisory review and approval.

Miscellaneous Revenues

- Observe separation of duties.

- Select a sample of miscellaneous revenue transactions, review for accuracy and indications of compliance with controls, and trace through accounting records and to deposits.

6. **SERVICE REVENUE AND RECEIVABLES—PROPRIETARY FUNDS**

- Observe billing, collection, and accounts receivable recordkeeping operations and inquire about the following:

  a. responsibilities of employees;

  b. how duties are reassigned during vacations or when key employees are otherwise absent; and

  c. frequency and handling of customer complaints and out of balance conditions.

- Select a sample of billings for services, and review for accounting accuracy and indications of performance of controls.

- Inspect reconciliations of accounts receivable detail to control account, and services provided to services billed, and review for supervisory review and approval.

7. **EXPENDITURES FOR GOODS AND SERVICES AND ACCOUNTS PAYABLE**

- Select a sample of expenditures (concurrently with cash disbursements) and review for indications of compliance with controls, correctness of account distribution, agreement of amount with supporting documents, and recording in correct period.

- Select a sample of purchases made using a debit or procurement card for indications of compliance with controls.

- Review list of long-outstanding checks for compliance with escheatment of abandoned or unclaimed funds.

- Inspect reconciliations and consider disposition of any significant discrepancies identified in reconciliations, and consider appropriate separation of duties and evidence of supervisory review and approval.

8. **PAYROLL AND RELATED LIABILITIES**

- Select a sample of employees from the payroll register. While performing the following procedures, consider appropriate separation of duties and evidence of supervisory review and approval.

  •• Compare pay rate to personnel records.

  •• Compare hours worked (or comparable factors) to time cards or reports and examine for required approval.

- Recompute gross pay.
- Consider the appropriateness of the expenditure account charged in light of the employee's position.
- Obtain justification for any unusual compensation.

- Examine selected payroll distribution summaries for supervisory review and approval and trace to the general ledger.

9. **INVENTORIES**

- Observe storage areas for compliance with separation of duties and safeguarding measures.
- If perpetual records are maintained, inspect evidence of test counts during the period and reconciliation to perpetual records and consider compliance with policies and procedures.
- Read inventory counting and pricing procedures and consider whether they provide reasonable assurance of an accurate and reliable physical inventory if followed.
- Inquire of officials responsible for supervising counting, pricing, and summarization, and inspect documentation of review.

10. **CAPITAL ASSETS AND CAPITAL EXPENDITURES**

- Select a sample of property and equipment (concurrently with cash disbursements), examine for indications of compliance with controls, and review for account distribution, agreement of recorded amount with supporting documents, and proper period.
- Evaluate the process for comparing budgeted and actual capital outlays for the period and inquire about handling of significant variances.
- Trace selected work orders for self-construction to closing and transfer to the capital assets listing and review for compliance with policies and procedures.
- Observe physical safeguarding controls when on the premises for other purposes and inquire about apparently idle assets noted during observation.
- Inquire about policies and procedures for reviews of depreciation, useful lives, salvage values, and allowance accounts and inspect documentation for compliance with policies and procedures.

11. **DEBT AND DEBT SERVICE EXPENDITURES**

- Read the minutes of the governing body for authorization to issue debt or enter into debt agreements and trace proceeds and obligations to recording in the accounting records and bank deposits.
- Review documentation of monitoring of compliance with debt restrictions, compliance with sinking fund requirements, and classification of leases as capital or operating, and consider compliance with policies and procedures.

12. **EQUITY AND FINANCIAL STATEMENT RECONCILIATIONS**

- Review minutes of meetings of the governing body; constitution, charter, statutes, and ordinances; debt issuance, documents; contribution and grant contracts; and other similar documents to identify the requirements and authorizations for equity restrictions and reserves.
- Inquire of government officials concerning the existence of equity restrictions, reserves, and designations.

- Inspect documentation supporting equity restrictions, reservations, and designations.
- Review workpapers supporting equity restrictions, reservations, and designations.
- Inspect reconciliations of the total fund balances from the fund financial statements to the government-wide financial statements.

13. **SELF-INSURANCE**

- Read the minutes of the insurance committee or the administrative procedures committee.
- Select a sample of insurance payments, obtain supporting documentation (e.g., claim file, documentation, determination of liability, claimant's release), and inspect for:
  - Proper approval.
  - Compliance with authority limits.
  - Existence of required documents.
  - Agreement among documents of details; i.e., claimant, amount, etc.

* * *

SELF-STUDY QUIZ

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

29. Which of the following accurately describes *walkthroughs*?

    a. They can independently always provide a sufficient basis for assessing control risk as low.

    b. They cannot serve as tests of operating effectiveness.

    c. They are used frequently in gaining an understanding of controls.

30. Reperformance of the control activity is characterized by all of the following **except**:

    a. Reperformance tests should be used if controls are tested when the control environment is not strong.

    b. When reperformance of control activities is applied to documented transactions, audit sampling is sometimes used in tests of controls.

    c. Reperformance tests are always performed independent from inspection of documents.

    d. Recomputing gross pay is an example of reperformance tests of controls.

SELF-STUDY ANSWERS

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

29. Which of the following accurately describes *walkthroughs*? **(Page 75)**

    a. They can independently always provide a sufficient basis for assessing control risk as low. [This answer is incorrect. Walkthroughs, along with other tests of controls, can provide a valid basis for assessing control risk at less than high. However, this approach generally by itself does not provide a sufficient basis for assessing control risk as low per SAS No. 110.]

    b. They cannot serve as tests of operating effectiveness. [This answer is incorrect. Testing operating effectiveness may include inquiries of appropriate personnel, observation of the entity's operations, inspection of relevant documentation, recalculation and the reperformance of the control, all of which are walkthrough procedures.]

    c. They are used frequently in gaining an understanding of controls. [This answer is correct. According to SAS No. 110, walkthroughs are used in gaining an understanding, or further understanding, of controls. Walkthrough procedures allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively.]

30. Reperformance of the control activity is characterized by all of the following **except**: **(Page 75)**

    a. Reperformance tests should be used if controls are tested when the control environment is not strong. [This answer is incorrect. Because they can be very time-consuming, reperformance tests should be avoided to whatever extent possible. Sometimes reperformance tests may be needed if the control is particularly significant or if controls are tested when the control environment is not strong per the Standards.]

    b. When reperformance of control activities is applied to documented transactions, audit sampling is sometimes used in tests of controls. [This answer is incorrect. According to the Standards, tests of controls that involve reperformance of control activities applied to documented transactions sometimes involve audit sampling.]

    c. Reperformance tests are always performed independent from inspection of documents. [This answer is correct. Reperformance tests are commonly performed along with inspection of documents per the Standards. Reperfomance acts as a dual-function test by providing substantive audit evidence about the transaction and the control activity. In this example, evidence is provided that the transaction is recorded in the proper account at the proper amount as well as that it was properly approved.]

    d. Recomputing gross pay is an example of reperformance tests of controls. [This answer is incorrect. Reperformance involves verifying data and facts by reperforming a sample of the work, thus examples of reperformance tests of controls include recomputing gross pay, tracing units billed from an invoice to a shipping document, or recomputing extensions and totals on sales invoices.]

PERFORMING TESTS OF CONTROLS

Testing controls includes obtaining evidence about:

- How controls were applied at relevant times during the audit period.
- The consistency of application.
- Who applied the controls or the means of their application.

The objective of performing tests of controls is to obtain assurance about their operating effectiveness to support the auditor's assessment of control risk.

This section discusses the timing of tests of controls, the extent of such tests, efficiency opportunities when testing controls, and other matters related to performing tests of controls. The nature of procedures used in tests of controls is discussed earlier in this lesson. Tests of IT related controls are discussed later in this lesson.

Timing of Tests of Controls

Tests of controls can be performed at a point in time or for a period of time. The appropriate timing depends upon the auditor's objective and for what period of time reliance is needed about the operating effectiveness of controls. When a control is tested at a point in time, the audit evidence can only support a conclusion about operating effectiveness at that point in time. Conversely, when a control is tested over a period of time, the audit evidence can be used to form a conclusion about operating effectiveness over that period.

In some cases, the control being tested need only be tested at a point in time. For example, for controls over the observation of the annual physical inventory of supplies, testing would only be relevant at that point in time because the controls are only applied once. Other controls, however, may operate throughout the audit period, requiring the auditor to collect evidence about operating effectiveness for the entire period. For an automated control that operates throughout the period, the auditor might be able to test the operation of the control at a point in time and collect evidence about its continued operation through tests of general controls.

Other considerations related to the timing of control tests include the following:

- Whether to perform the tests at an interim date or at period end.
- Whether to use audit evidence about the operating effectiveness of controls obtained in prior audits.

Interim Testing of Controls. Based on the audit strategy, the auditor might decide to perform tests of controls through an interim date prior to the date of the statement of financial position. SAS No. 110 (AU 318.37 and .38) requires the following when auditors perform tests of controls through an interim date:

- Auditors should determine what additional audit evidence should be obtained for the remaining period considering factors such as:
  - Significance of the assessed risks of material misstatement at the relevant assertion level.
  - Specific controls tested during the interim period.
  - Degree to which audit evidence about operating effectiveness was obtained.
  - Length of the remaining period.
  - Extent to which further substantive procedures will be reduced based on control reliance.
  - Control environment.

- Auditors should obtain audit evidence about the nature and extent of any significant changes in internal control, including changes in the information system, processes, and personnel that occur during the remaining period.

Additional audit evidence about the operating effectiveness of controls over the remaining period of time can be obtained by extending the tests of controls over the remaining period or testing the entity's monitoring of controls.

Using Audit Evidence Obtained in Prior Audits. SAS No. 110 explicitly recognizes that the auditor may be able to use audit evidence about the operating effectiveness of controls obtained in prior audits subject to certain defined restrictions. If these restrictions are met, the audit practice of rotating tests of controls over a three year cycle might be used. (However, evidence gained from testing controls in prior years would not be applicable when conducting a compliance audit or a Single Audit. When performing a compliance audit or a Single Audit, the auditor should test controls every year.) SAS No. 110 explains the following guidelines for rotating tests of controls:

- The auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit (AU 318.40). Rotation of testing is not appropriate if there have been changes.

- The evidence about whether changes in specific controls have occurred should include a combination of observation, inquiry, and inspection to confirm the understanding of those specific controls (AU 318.40). Inquiry alone is not enough.

- If a control has changed since it was last tested and the auditor plans to rely upon the control, it should be tested in the current audit (AU 318.41).

- The auditor should test a control at least once in every third year in an annual audit (AU 318.42).

- If a number of controls are rotationally tested, the auditor should perform some tests of controls each year (AU 318.44). It is not acceptable to test all controls in one audit period with no testing in the subsequent two audit periods.

- Rotation of testing is not permitted if the auditor plans to rely on those controls to mitigate a fraud risk or other significant risk (AU 318.45). For controls related to significant risks that require special audit consideration, the tests of controls should be performed in the current period.

- In considering whether rotation is appropriate and the time elapsed before retesting, the auditor should consider the factors in Exhibit 2-2 (AU 318.43).

Exhibit 2-2

Factors to Consider Regarding Rotation of Control Tests

Factor	Examples	Impact on Decision to Rotate Control Tests	Impact on Time Elapsed Before Retesting
Effectiveness of other elements of internal control, including the entity's control environment, monitoring, and risk assessment process.	• Design effectiveness and implementation of monitoring over relevant controls has improved.	• Rotation would generally be appropriate.	• Consider retesting every third year.
	• Deterioration in the design effectiveness and implementation of control environment or monitoring elements.	• Question the appropriateness of rotating tests.	• Consider shortening the time elapsed before retesting.

Factor	Examples	Impact on Decision to Rotate Control Tests	Impact on Time Elapsed Before Retesting
Whether the control is manual or automated.	• Control is automated and general IT controls are effective. • A manual control requires intricate steps and judgment on the part of the individual who performs it.	• Rotation would generally be appropriate. • Question the appropriateness of rotating tests.	• Consider retesting every third year. • Consider retesting each year.
Effectiveness of IT general controls.	• IT general controls are not designed or operating effectively.	• Depending on the significance of the general controls to the application control, rotation would generally not be appropriate.	• Consider retesting pertinent application controls each year (or consider the appropriateness of testing).
How the control is applied, including the nature and extent of deviations detected in prior audits.	• Testing of control in prior audits did not reveal any deviations. • Testing of control in prior year revealed one or more unresolved deviations. • New personnel in the current year with less experience and background who apply the control.	• Rotation would generally be appropriate. • Question the appropriateness of rotating tests, depending on the nature of the deviation. • Question the appropriateness of rotating tests.	• Consider retesting every third year. • Consider retesting each year, depending on the nature of the deviation. • Consider retesting in the current year.
Whether the control should have changed in response to changing circumstances but did not.	• Control remains unchanged from prior audits, but the changed circumstance does not impact the nature of the risk the control is addressing. • Control remains unchanged from prior audits, and the changed circumstance directly impacts the risk the control is addressing.	• Rotation would generally be appropriate. • Consider whether control remains appropriately designed prior to rotating control tests.	• Consider retesting every third year contingent upon the status of the changed circumstances. • If the control remains appropriately designed, consider the status of the changed circumstances when deciding how often to retest.

Factor	Examples	Impact on Decision to Rotate Control Tests	Impact on Time Elapsed Before Retesting
Risk of material misstatement and the extent of reliance on the control.	• Control risk is preliminarily assessed at moderate and planned substantive procedures will not be substantially modified. • Control risk is preliminarily assessed at low and planned substantive procedures will be extensively modified based on the planned reliance on the operating effectiveness.	• Rotation would generally be appropriate. • Question the appropriateness of rotating tests.	• Consider retesting every third year. • Consider retesting each year or every other year.

* * *

Rotation of tests of controls on a cyclical basis over three years is, thus, permitted, but the auditor has to obtain persuasive evidence that the controls have not changed in the current period and evaluate the appropriateness of relying on prior tests in the particular circumstances of the current period's audit. In other words, the auditor is still obligated to evaluate design effectiveness and determine whether the controls have been implemented each year.

Extent of Tests of Controls. AU 319.96 cautions the auditor to be aware that audit evidence obtained from some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied and, thus, may be insufficient for evaluating the design or operation of controls for periods not subject to such tests. SAS No. 110 (AU 318.46) requires auditors to design sufficient tests of controls to obtain sufficient appropriate audit evidence that the controls are operating effectively throughout the period of reliance. In doing so, the auditor might consider the following factors:

- The frequency that the control is performed during the period.
- The length of time that the auditor is relying on the control's operating effectiveness.
- The relevance and reliability of the audit evidence to be obtained in supporting whether the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
- The extent to which audit evidence is obtained from tests of other controls (including entity-level controls) related to the relevant assertion.
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (in order to reduce substantive tests).
- The expected deviation from the control.

Use of Audit Sampling in Tests of Controls

Risk assessment procedures performed to obtain an understanding of internal control do not involve sampling. Also, sampling ordinarily does not apply to the following types of tests of controls:

- Tests of automated application controls when effective IT general controls are present.
- Analyses of controls for determining the appropriate segregation of duties or other analyses that do not examine documentary evidence of performance.
- Analyses of the effectiveness of security and access controls.
- Tests directed toward obtaining audit evidence about the operation of the control environment, for example, inquiry or observation of the explanation of variances from budgets when the auditor does not plan to estimate the rate of deviation from the prescribed control.

- Examining actions of directors for assessing their effectiveness, for example, evaluating whether the audit committee is appropriately involved in the financial reporting process. (SAS No. 111, AU 350.32)

Generally, the auditor should consider using audit sampling for tests of controls in the following circumstances (SAS No. 110, AU 318.46):

- The control is applied on a transaction basis, for example, matching approved purchase orders to supplier invoices.

- The control operates frequently.

In these circumstances, the auditor can select a sample of transactions and reperform the related control activities to see whether compliance with the control procedures is acceptable. According to SAS No. 111 (AU 350.32), "sampling applies when the auditor needs to decide whether the rate of deviation from a prescribed procedure is no greater than the tolerable rate, for example, in testing a matching process or an approval process."

Specialized Considerations for a Governmental Unit. Best practices indicate that an efficient sampling approach is to perform tests of controls simultaneously with tests of compliance with laws and regulations (a dual-purpose test). Additionally, those tests may sometimes serve as a substantive test of one or more account balances (a triple-purpose test). Audit procedures designed to test compliance with applicable laws and regulations for expenditures charged to major federal award programs will simultaneously test the operating effectiveness of control activities designed to ensure compliance with those laws and regulations. In some cases, there is no real distinction between tests of compliance with program requirements and tests of controls over program requirements.

Concurrent Tests of Controls and Substantive Procedures

SAS No. 110 (AU 318.33) states that the auditor may perform a test of controls concurrently with a substantive test of details on the same transaction. Such a dual purpose test has two objectives—to obtain evidence about the control's operating effectiveness and to detect material misstatements in the account balance or transaction class. For example, while inspecting a vendor's invoice and recalculating amounts as a substantive procedure to detect material misstatements, the auditor might also determine from notations on the invoice that client personnel performed control activities such as checking the mathematical accuracy, approval, etc. These procedures would confirm information obtained about control activities from inquiry of an employee.

SAS No. 110 (AU 318.34) states "the absence of misstatements detected by a substantive procedure [that is, a single-purpose test] does not provide evidence that controls related to the relevant assertion being tested are effective." However, detection of a misstatement by a substantive procedure should be considered in assessing the operating effectiveness of controls. In other words, the auditor should not assume that controls are effective just because a substantive procedure does not detect a misstatement. Thus, it is not appropriate to consider a substantive procedure as a dual purpose test merely because no misstatements are detected.

Efficiency Opportunities in Testing Controls

Audit efficiencies can be achieved by testing controls if the tests and resulting control risk assessment provide a basis for reducing the extent of substantive procedures. The auditor may decide that the time spent testing controls in order to support a lower control risk assessment and reduction in substantive procedures will result in even greater time savings in substantive testing. Nevertheless, tests of controls, particularly tests involving reperformance and document inspection, can be time consuming. Testing controls is often associated with time-consuming detail testing of documents and transactions, perhaps using sampling. However, testing controls need not necessarily include such detail testing. There are other, more efficient ways of testing controls that may provide sufficient evidence. Also, many auditors erroneously assume that if a transaction is tested, all controls related to the transaction must be tested. However, only those controls that relate to the reliability of financial statements need be tested.

Exhibit 2-3 presents a summary of efficiency opportunities in testing controls. The items in the list are presented in order of importance.

Exhibit 2-3

Efficiency Opportunities in Testing Controls

1. In deciding how much attention to give to controls, first consider the materiality and inherent risk for the audit area. It may be possible to reduce the extent of substantive procedures based on materiality and the assessment of inherent risk even if control risk is assessed as high. Then, no further attention to control risk or tests of controls would be necessary for the area.

2. Do not attempt to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures. An assessment of control risk as low will require obtaining more evidence than will an assessment of moderate.

3. Before testing controls, consider whether the understanding of controls obtained indicates that controls appear to be suitably designed and implemented. Do not test controls that do not appear to be effective.

4. Consider whether procedures performed to obtain an understanding of the design and implementation of controls, such as inquiry, observation, or walkthroughs, can also serve as a test of controls and provide evidence about operating effectiveness. If such procedures are not sufficient to support a reduced assessment of control risk, the auditor should only consider the incremental costs of performing additional testing procedures (compared to the costs already incurred to evaluate design and implementation) when making a decision whether to test the controls from an efficiency perspective.

5. Consider evidence provided by tests of controls performed in prior audits. Consider whether there have been any changes in the controls, and if not, consider performing tests over a three year cycle, as permitted by SAS No. 110. Also, when making decisions about the efficiency of testing a control not previously tested in prior years, consider the costs of testing from the perspective of a potential benefit for three engagements, especially if controls are not expected to change.

6. Consider whether substantive testing of the account balance or transaction class may provide evidence about the control risk related to the account or transaction class. (Where material misstatements could exist, substantive procedures can never be eliminated entirely based on inherent and control risk assessments; thus, the auditor will expect to perform some substantive procedures.) If so, the nature or extent of tests of controls may be limited.

7. Consider whether it is more efficient to test IT general and application controls rather than substantively testing certain computer-produced reports used in the audit. If so, consider reducing the extent of testing of a programmed application control if relevant IT general controls have been tested and found to be effective.

8. Do not test the operation of processing procedures unless the test provides evidence as part of a dual-purpose procedure. Instead, test only controls that are relevant in preventing or detecting misstatements in the financial statements. Do not test operational or efficiency controls that are not relevant to preventing or detecting misstatements. Also, the auditor does not have to seek a reduced control risk assessment for all assertions related to an account balance or transaction class. Rather, only test controls related to the assertions or risks of misstatement of the account balance or transaction class that concern the auditor.

9. Use inquiry, observation, and walkthroughs to the maximum extent possible as tests of controls.

10. Use reviews of reconciliations and similar bookkeeping routines to the extent appropriate. This is a more efficient, nonsampling test of controls than reperformance of control procedures.

11. To save time when there is the expectation that tests of controls will be necessary or efficient, consider performing tests of controls at the same time as obtaining an understanding of controls or performing a substantive test of transactions.

12. Consider which controls, if effective, would provide a basis for reducing the extent of planned substantive procedures, then test those controls.

13. In choosing procedures to test a control, consider the degree of assurance provided by the procedure in relation to the degree needed. If there is a choice, choose the procedure that is most efficient in providing the needed degree of assurance.

14. If a test of transactions is planned for a high-risk area (such as a test of cash disbursements because of increased risk of theft of cash), obtain maximum benefit by combining the test of details with a test of controls. This may allow the auditor to limit vouching in other areas.

* * *

Using Single Audit Tests in Financial Statement Audits. The auditor should consider ways to use the Single Audit required tests of controls to reduce the substantive testing in the financial statement audit. Consider whether any tests of controls performed as part of the Single Audit or other compliance audit also relate to the audit areas in the financial statement audit. Those tests of controls may reduce the need for additional tests of controls. In addition, also use the transactions selected for Single Audit control testing to test for compliance (dual-purpose testing) and to reduce the extent of other substantive procedures for testing the financial statement amounts (triple-purpose testing).

SELF-STUDY QUIZ

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

31. Which of the following statements regarding the testing of controls is accurate?

    a. Tests of controls are not required to only be performed at a particular point in time.

    b. Testing of controls is rarely efficient.

    c. Substantive procedures can always be performed without testing controls.

    d. The auditor cannot use audit evidence about the operating effectiveness of controls obtained in prior audits.

32. Which of the following scenarios regarding the use of audit evidence obtained in prior audits is most accurate?

    a. Pauley is engaged in an audit of North University. Pauley notices that changes in specific controls have occurred subsequent to the prior year and rotates the tests.

    b. Adrian is engaged in an audit of the City of Durant. Adrian intends to rely on the operating effectiveness of controls intended to mitigate a significant risk. The controls were tested in last year's audit.

    c. Sylvester is engaged in an annual audit of Rocky University. Sylvester must test RR's key controls once every three years.

33. Why would you **not** want to try to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures?

    a. It could negatively affect engagement economics.

    b. To achieve an expectation of operating effectiveness.

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.)**

31. Which of the following statements regarding the testing of controls is accurate? **(Page 83)**

    a. Tests of controls are not required to only be performed at a particular point in time. [This answer is correct. Tests of controls can be performed at a particular point in time, or for a period of time. Per SAS No. 110, testing controls over a longer period of time provides more evidence of the effectiveness of controls.]

    b. Testing of controls is rarely efficient. [This answer is incorrect. Testing of controls is generally efficient but sometimes may be inefficient. For example, testing controls if the evaluation of their design indicates that they are not suitably designed or implemented would not be efficient.]

    c. Substantive procedures can always be performed without testing controls. [This answer is incorrect. Because of the importance of effective controls over accuracy and completeness in processing, it may be impractical or impossible to perform only substantive procedures without testing controls per SAS No. 109.]

    d. The auditor cannot use audit evidence about the operating effectiveness of controls obtained in prior audits. [This answer is incorrect. The risk assessment standards permit the auditor to use audit evidence about the operating effectiveness of controls obtained in prior audits subject to certain defined restrictions per SAS No. 110.]

32. Which of the following scenarios regarding the use of audit evidence obtained in prior audits is most accurate? **(Page 84)**

    a. Pauley is engaged in an audit of North University. Pauley notices that changes in specific controls have occurred subsequent to the prior year and rotates the tests. [This answer is incorrect. If Pauley obtains audit evidence regarding changes in those specific controls that have occurred subsequent to the prior he should not rotate testing per SAS No. 110.]

    b. Adrian is engaged in an audit of the City of Durant. Adrian intends to rely on the operating effectiveness of controls intended to mitigate a significant risk. The controls were tested in last year's audit. [This answer is incorrect. According to SAS No. 110, rotation of testing is not permitted if Adrian plans to rely on those controls to mitigate a fraud risk or other significant risk. For controls related to significant risks that require special audit consideration, the tests of controls should be performed in the current period.]

    c. Sylvester is engaged in an annual audit of Rocky University. Sylvester must test RR's key controls once every three years. [This answer is correct. According to SAS No. 110, one guideline for rotating tests of controls is an auditor should test a control at least once in every third year in an annual audit.]

33. Why would you **not** want to try to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures? **(Page 88)**

    a. It could negatively affect engagement economics. [This answer is correct. When considering the efficiency opportunities in testing controls, auditors should not attempt to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures because an assessment of control risk as low will require obtaining more evidence than will an assessment of moderate, resulting in more hours spent on the engagement which negatively affects engagement economics.]

    b. To achieve an expectation of operating effectiveness. [This answer is incorrect. An expectation of operating effectiveness typically means that the auditor's planned control risk assessment is less than "high." This means the assessment could be either low or moderate.]

TESTING IT RELATED CONTROLS

The auditor's approach to testing IT controls is not fundamentally different than testing other control activities. The auditor's primary consideration is whether and how a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. The auditor focuses on those control activities that address areas in which the auditor believes material misstatements are likely to occur. In the IT environment these control activities are application controls.

How a Client's Computer Affects Internal Control

Many small to medium-sized governmental units have simple computer operations. They use personal computers, which may be linked in a local area network (LAN), and purchased software packages. The computer users often do not have specialized computer training and cannot write or edit computer programs.

Other governmental units may use the Internet or sophisticated information technology (IT) systems to conduct operations and may have internal control that is heavily dependent on IT. They may have highly integrated IT systems that share data and are used to support all aspects of financial reporting and operations.

The computer system of either type of entity affects the way transactions are initiated, authorized, recorded, processed, and reported and, thus, its internal control. Furthermore, it may affect any of the five components of internal control that are relevant to the financial reporting, operations, or compliance objectives. The effect on the entity's internal control is related more to the nature and complexity of the system than to the entity's size. For example, an entity with a simple computer system may use primarily paper-based manual procedures and manual controls, such as approvals, reconciliations, reviews, and follow-up of exceptions.

An entity with a complex IT system might use automated procedures to initiate, authorize, record, process, and report transactions. Records may be in electronic format rather than in paper form. Controls in that environment generally consist of a combination of manual controls and automated (computer) controls such as controls programmed within computer systems. Automated controls include processes such as edit and validation routines embedded in computer programs. In addition, the nature of the manual controls may be different. Manual controls in an automated system may be independent of the computer 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 entity's system.

SAS No. 109 (AU 314.60) identifies the following risks that IT systems pose to internal control:

- Reliance on systems or programs that are incorrectly processing data, processing inaccurate data, or both.
- Unauthorized access to data resulting in destruction or improper changes to data.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Loss or destruction of data or inability to access data as required.

The extent and nature of these risks depend on the nature and characteristics of the entity'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 entire database and result in improper changes to or destruction of data.

SAS No. 110 (AU 318.24) notes that when an auditor has determined that it is not practical or possible to reduce detection risk to an acceptable level by using only substantive procedures, then tests of the operating effectiveness of controls should be performed. These situations may be encountered when a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported and no documentation of transactions is produced or maintained, other than through the IT system.

Types of Computer Control Activities

SAS No. 109 (AU 314.92) indicates that the auditor should obtain an understanding of how IT affects control activities that are relevant to the audit. The SAS further discusses (a) application controls and (b) general controls, two types of computer control activities.

Application Controls. Application controls apply to the processing of individual transaction applications (such as payroll and purchases) and relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data. Application controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data and numerical sequence checks.

Application controls may be performed by IT, referred to as *automated controls*, or by individuals, referred to as *user controls*.

User controls might include checks of the completeness and accuracy of computer output against source documents or other input and manual follow-up of exception reports. For example, a computerized payroll system might calculate all debit and credit amounts from transaction data and a master file. The user control would be to manually check the accuracy of the output produced by the computer by recomputing amounts such as gross pay. Best practices indicate that user controls also include certain reconciliation and processing controls over computer-generated data, such as reconciling subsidiary ledgers to control accounts, and accounting for the sequence of source documents. The effectiveness of user controls such as reviews of computer-produced exception reports may depend on the accuracy of not only the review, but also of the information in the report. Thus, if the auditor tests the manual follow-up activities, the auditor should also test the accuracy of the computer-produced reports.

General Controls. The continued effective functioning of application controls often depends on general controls. General controls are policies and procedures that relate to many applications. General controls are directed at ensuring the continued proper operation of information systems, thereby supporting the effective functioning of application controls. General controls include the following types of controls:

- Controls over data center and network operations.
- Access security.
- System software acquisition, change, and maintenance.
- Application system acquisition, development, and maintenance.

General controls are important, but unless the auditor pays careful attention to their relation to the risks of material misstatement, the time spent on general controls can be unproductive. The auditor should view general controls in relation to their effect on applications and data that become part of the financial statements. This means that the auditor first focuses on identifying applications that are significant to the financial statements. Then the auditor assesses whether there are general controls that if ineffective would permit application controls to operate improperly and allow misstatements to occur and not to be detected. The auditor can then perform tests of those general controls that are important to the effectiveness of application controls on which the auditor plans to rely.

Approaches to Testing Computer Controls

To test computer controls, one or more of the following approaches may be used:

- Test general controls and manual follow-up procedures.
- Test manual user controls.

- Test automated application controls and manual follow-up activities.

Test Manual User Controls. Effective user controls may provide assurance with respect to the completeness and accuracy of computer-processed transactions. User controls may also provide evidence that the automated application controls are operating effectively. For example, the client may have manual procedures that effectively determine that the detailed listing of accounts payable is complete and accurate. In that situation, the auditor may be able to focus solely on user controls in that area. If user controls are limited to checking completeness, other procedures may be needed to provide assurance about accuracy. That approach is better suited to simple financial reporting systems.

Test Automated Application Controls and Manual Follow-up Activities. Some auditors may determine it is necessary to test automated application controls and manual follow-up activities. Because IT processing is inherently consistent, the auditor may be able to limit the testing of automated application controls to one or a few instances of the control application. Generally, an automated control will function consistently unless the program or related stored data are changed. Consequently, the auditor needs to perform tests of controls to determine that (1) an automated control is functioning effectively and (2) the control continues to function effectively. For example, a programmed application control should function consistently unless the program is changed. However, to reduce the extent of application controls testing, the auditor would need to determine that relevant general controls are operating effectively during the period. For example, when obtaining audit evidence on operating effectiveness of related general controls, tests might include determining that the authorized version of the program is used to process transactions, that unauthorized changes to the program are not made, and that program changes are subject to appropriate program change controls.

When applicable to the relevant assertion, the auditor would normally test manual follow-up activities (for example, the activities used to follow up on items listed in an exception report). The follow-up activities include investigation and correction of the exception items. If manual follow-up activities are tested, the auditor should consider whether those activities depend on computer-related controls. For example, if a client's procedures for following up on exception reports (such as unmatched documents or past due accounts) are based on computer reports, such procedures depend on programmed controls to ensure accuracy. Such situations may require tests of both programmed controls and manual follow-up procedures to avoid placing inadvertent reliance on the computer. That is, the auditor should either test the accuracy of the computer-produced exception reports (for example, does the report include past-due accounts?) or should test the client's procedures for determining that the computer-produced reports are accurate.

An approach that tests automated application controls may be inefficient because the tests often involve CAATs and are performed at given points in time, and thus do not provide evidence about the consistent operation of the control activity during the period under audit without testing the operating effectiveness of related general controls. It could be costly to perform the tests at several points throughout the period. Also, some testing procedures, such as program code analysis, require specialized technical skill. Thus, focusing solely on programmed application controls may often not be practical. Nevertheless, the auditor may have to test automated application controls in some situations.

Test General Controls and Manual Follow-up Activities. Effective computer general controls help ensure that automated application controls are designed properly and operating consistently throughout the period. Effective manual follow-up procedures provide assurance about the completeness and accuracy of computer-processed transactions, and they may also provide evidence about the effectiveness of automated application controls. Accordingly, the auditor may be able to support a control risk assessment below "high" by obtaining an understanding of the design and implementation of application controls and by understanding and testing general controls and manual follow-up activities. This approach provides evidence about the effectiveness of design and operation of the automated application controls.

A testing approach that focuses on general controls may often apply to financial reporting systems that are heavily dependent on complex computer systems. The tests are performed to obtain evidence of the following:

- Programs are properly designed and tested in development.
- Changes to programs are properly made.

- Adequate access controls reduce the risk of unauthorized changes to the program and data files.

For example, to test whether changes to programs were properly made, the auditor might perform the following procedures:

a. Inquire of the data processing manager about program changes and adherence to established programming standards.

b. Inquire of user department managers about their involvement in the approval and testing process.

c. Examine the following documents:

    (1) Written approvals by appropriate department managers and the data processing manager for the changes.

    (2) Program maintenance reports and logs of the program development manager.

    (3) Final documentation of the revised program.

To test whether unauthorized changes have been made to programs, the auditor might obtain a copy of the program and use CAATs to compare it with the program actually used in the computer to process data. Differences would indicate that unauthorized changes had been made to the program.

To test general controls over access to programs and data files, the auditor might perform the following procedures:

- Gain an understanding of access security software packages used by the client.
- Inquire of programming and data processing personnel about access controls, such as what the security procedures are, whether programmers are authorized to operate the computer, and circumstances when they might have access to the computer.
- Observe physical access to programs and data.
- Examine use logs generated by security software.
- Examine documentation of past instances of unauthorized attempts to access the computer and how such attempts were prevented or detected.
- Attempt to gain unauthorized access to programs and data using improper passwords. (Client authorization to perform this procedure should be obtained first.)

As previously mentioned, many small governmental units do not develop or modify computer programs but instead purchase software packages. The tests of controls over program changes and access in the preceding paragraphs would generally not be relevant to such entities if the client does not have access to the program code to make changes.

Need for a Specialist to Test Computer Controls. The auditor should consider whether individuals with specialized IT skills are needed in performing the audit. A specialist may be needed to perform tests of general or automated application controls (as well as substantive procedures involving IT). A computer specialist may be either a member of the auditor's firm or an outside professional. When a specialist is needed, the auditor is required to determine whether the individual will effectively function as a member of the audit team. SAS No. 108 (AU 311.23) identifies the following factors to consider in deciding whether an IT specialist is needed:

- The complexity of the entity's system and IT controls and the way in which they are used in conducting the business.
- The significance of changes made to existing systems or the implementation of new systems.

- The extent to which data is shared among systems.
- The extent of the entity's participation in e-commerce.
- The entity's use of emerging technologies.
- The significance of audit evidence that is available only in electronic form.

An IT specialist may be needed if the computer system is complex, such as when the following conditions exist:

- Client personnel have access to source code of significant accounting applications, which allows them to write or edit computer programs.
- The client's software has been developed internally or modified substantially (rather than using purchased software packages with no modifications).
- Client personnel have extensive remote access to computer programs and files (other than the ability to make routine inquiries).
- The client uses a large mainframe system with complex communications hardware and software.
- The client uses a local area network (LAN) that is complex or has multiple levels of controls.
- The client's financial reporting system depends heavily on automated application controls for significant accounting applications (that is, manual controls alone may not be adequate to prevent or detect material misstatements in computer-processed information).

In a situation involving complex systems, a computer specialist may be asked to perform the following types of procedures:

- Inquire how transactions are initiated, recorded, processed, and reported.
- Inquire about the design of controls.
- Inspect systems documentation.
- Observe the operation of controls.
- Plan and perform tests of controls.

If the auditor uses a computer specialist on the engagement team, 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 evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures. That does not mean that auditors have to be experts in IT. When the IT specialist is part of the audit team, the auditor's responsibilities for supervising the specialist are the same as for other members of the engagement team, as provided by SAS No. 108. To effectively supervise a computer 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 attendance at training classes or seminars. If the firm uses an outside professional, the guidance in SAS No. 73 (AU 336), *Using the Work of a Specialist*, should be considered.

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.

Testing Procedures

The procedures discussed earlier in this lesson (that is, inquiry; observation; inspection of documents, reports, and electronic files; walkthroughs; review of reconciliations; and reperformance of the control activity) may be used to test computer control activities. Also, evidence about the operating effectiveness of computer controls may be obtained from tests of computer controls performed in prior audits. Preceding paragraphs give examples of procedures for testing computer general controls. The following paragraphs give examples of testing procedures for manual follow-up activities and testing procedures using CAATs.

Testing Procedures for Manual Follow-up Activities. Some examples of testing procedures for manual follow-up activities include the following:

a. Inquiry of the employee performing manual follow-up activities about matters such as:

   (1) the frequency and extent of differences between operational and accounting data that show up on exception reports,

   (2) whether items appear on exception reports on a timely basis, and

   (3) how long it usually takes for items to clear from exception reports.

b. For enterprise funds, inquiry of accounts receivable or customer service personnel about:

   (1) the frequency of customer complaints about incorrect computer-generated billings,

   (2) the causes of such misstatements, and

   (3) the corrective steps taken in response to complaints.

c. Examination of correspondence with customers and other parties about complaints.

d. Inquiry of operating department personnel about the accuracy of items listed on computer-generated exception reports used in manual follow-up activities.

e. Examination of some computer-generated exception reports to determine that items that should be on the reports appear on them (so that they can be manually followed up) and cleared on a timely basis.

Testing Procedures Using CAATs. Some examples of testing procedures using CAATs that may be performed when there is not documented evidence of an automated application control activity include the following:

- Selecting several items from a processing run, processing them separately, and checking the accuracy of the separate run.

- Simulating a condition that would be expected to produce an exception report if the programmed control is operating effectively, such as withholding a document from a batch of sequentially numbered documents and processing the batch to see if the IT system reports the missing document.

- Obtaining a special printout of items processed when the IT system does not normally print such a report.

- Inputting fictitious data and comparing the predicted results with the actual results to see whether the IT system accurately processed the fictitious items. This procedure can be used to test the operation of several programmed procedures at once.

TESTS OF CONTROLS AND ASSESSING CONTROL RISK—EVALUATION

After performing tests of controls, the auditor evaluates the results of the tests and the persuasiveness of the evidence obtained in reaching a control risk assessment for a particular audit area and assertion. The control risk assessment can be at high for some or all assertions and at less than high for others. It is not necessary to attempt to assess control risk as low if an assessment as moderate will support the planned extent of substantive procedures. An assessment of low control risk requires more audit evidence than an assessment of moderate control risk.

The results of control tests may support a planned control risk assessment of moderate or low or may cause the auditor to reconsider the planned control risk assessment. SAS No. 109 (AU 314.121), states:

> When the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and should further modify planned audit procedures accordingly.

If the actual assessment supported by the control tests differs from the planned risk assessment, the auditor should consider adjusting the planned extent of substantive procedures. The adjustment of substantive procedures is a necessary matter of audit effectiveness (to prevent underauditing) if the actual control risk assessment is higher than the planned risk assessment but is only a matter of audit efficiency (to prevent overauditing) if the actual control risk assessment is lower than the planned assessment. As the audit progresses, the auditor should continue to evaluate whether audit evidence from performing substantive procedures suggests a need to reconsider the control risk assessment. The remainder of this section addresses Single Audit considerations, the auditor's evaluation of evidence from tests of controls, the amount of evidence needed to support a reduced control risk assessment, and the effect of the control risk assessment on substantive procedures.

Evaluating the Evidence about Operating Effectiveness

Test of controls may detect deviations from prescribed procedures. SAS No. 110, (AU 318.72) indicates:

> The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur.

Deviations might be caused by the following factors:

- Changes in personnel.
- Human error.
- Significant fluctuations in the volume of transactions.

It is important for the auditor to not draw an immediate conclusion about the operating effectiveness of a control when a deviation is detected. Instead, the auditor should understand the cause of the deviation and its implication by making specific inquiries. In some cases, a deviation in a control activity might result from the ineffective operation of an indirect control such as the control environment or IT general controls. In such cases, to understand the deviation, the auditor may wish to make inquiries or perform other tests related to indirect controls. The auditor should not assume that a deviation or minor weakness necessarily means that control risk is high. The controls should be evaluated as a group. Other strong or effectively operating controls might compensate for the weak or ineffectively operating one. However, SAS No. 110 (AU 318.73) indicates that an auditor should not assume that an instance of fraud or error is an isolated instance; again, careful analysis should be made to determine how it may impact the assessed risk of material misstatement.

Based on the test results, the auditor should determine whether:

- Tests results provide an appropriate basis for reliance on controls.
- Additional tests of controls are necessary.
- Potential risks of misstatement need to be addressed using substantive procedures.

For example, if the tests of controls result in deviations, the auditor may be able to support a reduced control risk assessment by expanding the test of controls after first understanding and isolating the nature of the deviation and its potential implication, or by testing other controls that accomplish the same objective as those being tested. If the auditor determines that the tests indicate that reliance cannot be placed upon the controls, no further testing would be performed. At that point, the auditor would reassess the risk of material misstatement and the response through substantive procedures. However, even if the results of the tests support an assessment of control risk at a lower level, the auditing standards require auditors to design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Thus, some substantive procedures are always necessary.

Evaluating the Operating Effectiveness of Controls at a Service Organization. In situations where the government uses a service organization, the auditor may decide to rely on controls that are maintained and implemented by the service organization. In such cases, the auditor should obtain evidence about the operating effectiveness of relevant service organization controls.

Considering Evidence from Substantive Procedures. A lack of misstatements as a result of substantive procedures does not provide audit evidence about the operating effectiveness of controls, but the reverse is not true. SAS No. 110 (AU 318.34) indicates that a material misstatement detected through the performance of substantive procedures "that was not identified by the entity is evidence of a deficiency in internal control and may be a significant deficiency or a material weakness in internal control."

Communicating Internal Control Deficiencies. SAS No. 115 (AU 325) provides guidance on the auditor's responsibility to communicate significant deficiencies and material weaknesses in internal control to management and those charged with governance. The results of control testing, as well as the evaluation of design and implementation required in understanding internal control, are potential sources of identified control deficiencies. Identified deficiencies should be evaluated as to whether they represent, individually or in combination with other deficiencies, significant deficiencies or material weaknesses that are required to be communicated.

Compliance Audit SAS Reporting Requirements. SAS No. 117 (AU 801), *Compliance Audits*, requires auditors to communicate significant findings from the compliance audit. Even if there is not a specific governmental audit requirement to report on internal control over compliance, SAS No. 117 still 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.

Government Auditing Standards Requirements. Auditors have additional communication requirements in audits performed under *Government Auditing Standards*. The Yellow Book requires auditors to issue a written report that describes the scope of their testing of internal control over financial reporting and reports significant deficiencies and material weaknesses in internal control.

Considering the Amount of Audit Evidence Necessary to Support a Control Risk Assessment

SAS No. 110 (AU 318.28) states:

> As the planned level of assurance increases, the auditor should seek more reliable or more extensive audit evidence. In circumstances in which the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor should perform tests of controls to obtain a higher level of assurance about their operating effectiveness.

Thus, in choosing procedures to test a control activity, the auditor should consider the degree of assurance provided by the procedure in relation to the degree of assurance needed to support a control risk assessment and reduction of substantive procedures. If there is a choice, the auditor should choose the available testing procedure(s) that is (are) most efficient in providing the needed degree of assurance. The following paragraphs discuss factors that affect the assurance provided by particular tests of controls.

The lower the assessed level of control risk, the greater the quantity of audit evidence that should be obtained and the greater the assurance the evidence must provide in support of the assessment. SAS No. 110 (AU 318.47 and 318.48) state that "to reduce the extent of substantive procedures in an audit, the tests of controls performed by the auditor need to be sufficient to determine the operating effectiveness of the controls at the relevant assertion level and the level of planned reliance. . . . The auditor should increase the extent of tests of controls the more the auditor relies on the operating effectiveness of controls in the assessment of risk."

Audit evidence varies substantially in the assurance it provides the auditor in developing an assessment of control risk. The quantity and persuasiveness of audit evidence that is sufficient to support a specific risk assessment is a matter of professional judgment. In reaching this judgment, the following factors should be considered:

a. *The Type of Evidence Obtained.*

b. *The Source of the Evidence.*

c. *The Timeliness of the Evidence.*

d. *Whether Other Evidence Related to the Risk Assessment Exists and Supports or Contradicts the Same Conclusion.* This includes the following:

   (1) Evidence that may have been obtained about the entity and its environment or while gaining an understanding of the design and implementation of controls.

   (2) Evidence that may have been obtained about another control component, because the five control components are interrelated. For example, the control environment is pervasive, and a good (or poor) control environment may positively (or negatively) affect the effectiveness of other control components.

Type of Evidence. The nature and types of control tests are discussed earlier in this lesson, SAS No. 110 (AU 318.30) states that "the nature of the particular control influences the type of audit procedures necessary to obtain audit evidence about whether the control was operating effectively . . . ." For some controls, evidence about their design or operation may exist in documented form that the auditor may inspect. Usually, the knowledge and objectivity of the person who performed the control activity being tested by document inspection or reperformance are less critical to the auditor because there is objective evidence of the performance of the control activity and its result. This is in contrast to inquiry as a testing procedure where the respondent's knowledge or objectivity may affect the reliability of the response.

Document inspection and reperformance of the control activity are not always foolproof. Just because the auditor inspects a notation purporting to evidence performance of a control activity, or reperforms a control with no errors or exceptions being found, does not necessarily mean that the person who made the notation actually performed the control activity. For example, suppose the auditor inspects a clerk's initials on a ticket copy purporting to indicate that the clerk recalculated the fine amount. The auditor recalculates the fine amount and finds no exceptions. Still, the initialed ticket copy and auditor's successful recalculation do not necessarily mean that the clerk had in fact recalculated the fine.

Another problem with document inspection is that employees may perform a control activity but may not initial or place another identifying mark on documents to indicate that they did perform the activity. In such a situation, even though the control activity was performed, there is no documentation of that fact for the auditor to examine. In that case, document inspection cannot be counted as a source of evidence.

For some controls, there is no documentation of design or operation. For example, there may be no documentation of segregation of duties or control activities performed by the information technology system. In such cases, the auditor may have to use inquiry, observation, or CAATs to obtain evidence about the design or operation. For example, the auditor might observe the clerk opening the mail and listing cash receipts for service fees of an enterprise fund before sending the receipts to accounting.

Exhibit 2-4 summarizes key considerations for evaluating the types of evidence obtained from the control testing procedures discussed earlier in this lesson.

Exhibit 2-4

Types of Evidence Considered in Assessing Control Risk

Types of Evidence	Common Uses	Limitations	Examples of Controls Being Tested
Inquiry and observation	Especially useful in assessing the effectiveness of controls that do not leave a documentary trail of their performance.	Persuasiveness is sometimes limited because the evidence may only apply to the period of time the auditor is present.	• Segregation of duties, especially where there is no documented or other system evidence of performance. • Controls over counts of physical inventory. (Inspection of documents might also be used.)
Inspection of client documents (including reconciliations and other routines)	Can provide strong evidence about operating effectiveness, especially for controls relating to reconciliations and other documented routines.	Degree of persuasiveness depends on the extent of procedures (sample sizes, number of months reviewed, etc.). Primarily used to test controls that leave a documentary trail of their performance.	• Review of cash account reconciliations. • Independent review and approval of journal entries and supporting documentation prior to posting. (Reperformance might also be used in each example.)
Reperformance	Can provide strong evidence about operating effectiveness, especially when used with document inspection tests.	Degree of persuasiveness depends on the extent of procedures (sample sizes, number of months reviewed, etc.). Can be very time-consuming.	• Controls over the matching of invoices, receiving reports, and purchase orders. • Management review and approval of analyses of receivables allowances, other reserves, and estimates. (Inspection of documents would also be used in each example.)

Types of Evidence	Common Uses	Limitations	Examples of Controls Being Tested
Walkthroughs	May be useful in evaluating the design and implementation of controls.	The degree of persuasiveness depends on the extent of other evidence obtained about operating effectiveness.	• When obtaining an understanding of internal control, a walkthrough of a transaction is performed from the receipt of goods and the vendor invoice through recording in the general ledger that involves the use of inquiry, observation, inspection of documents and reperformance, where applicable, of key control activities.
Prior audits	Tests of controls from prior audits may provide some evidence about the effectiveness of controls.	Persuasiveness is sometimes limited because controls' effectiveness may have changed since the prior audit.	• For the 20X1 engagement, the auditor tested controls over the review of capital assets costs and variances. For 20X2, the auditor decides to use that evidence about the operating effectiveness of the controls for the assessed risk of material misstatement and modifying the nature of substantive procedures relating to capital assets (assuming there are no significant fraud risks). The auditor obtains appropriate audit evidence regarding whether changes have occurred in those specific controls and the surrounding circumstances.

* * *

Source of Evidence. Evidence about controls obtained directly by the auditor generally provides more assurance than evidence obtained indirectly. For example, evidence obtained by observation generally provides more assurance than evidence obtained by inquiry. In the first case, the auditor observes a control procedure being performed; in the second case, the auditor is merely told that it was performed.

Although observation is generally superior to inquiry, the auditor should keep in mind that the observed control activity might not be performed in the same manner when the auditor is not present. Generally, the stronger the control environment is, the more likely it is that the observed activity is performed consistently at times when it is not observed. Thus, the stronger is the control environment, the more persuasive is evidence provided by observation. Also, more evidence can be obtained by performing the observation several times during the period. Similarly, the strength of inquiry as a source of audit evidence can be increased by asking more than one person about the same control activity.

Evidence obtained from externally produced documents, records, or reports is more persuasive than evidence from ones produced internally. The internally produced documents, records, or reports may have a greater potential for being biased than externally produced ones. However, operational data and reports produced internally but apart from the accounting and financial reporting function, such as an inventory manager's reports of units received or reports of internal auditors, can have a "quasi-independent" nature. Also, evidence from internally produced documents is more persuasive if the control environment is strong.

Considering Evidence about the Operation of Entity-level Controls. In some situations, the auditor may be able to support a lower assessed level of control risk for an assertion by considering evidence about the operation of entity-level controls. For example, in order to achieve a planned level of control risk assessment, the auditor might be able reduce the extent of tests of a key control activity through evidence gathered about the operation of controls from the control environment or monitoring components of internal control. In some situations where a control activity and a control from an entity-level component both contribute to the prevention, or detection and correction, of a material misstatement, the auditor may deem it necessary to obtain evidence about the operating effectiveness of both controls. For example, a key control activity relating to completeness might be a reconciliation routine that includes investigation and resolution of items that were not posted to the general ledger account. Management, as part of its risk assessment process, has determined that due to the inherent risks for the account along with the volume and complexity of reconciliations, being performed by accounting personnel that a monitoring control consisting of management review over the timely and proper completion of the reconciliation is important to minimize the risk relating to the completeness assertion. In this case, the auditor may deem that both controls should be tested.

When evidence exists about the operation of an entity-level control that contributes to a lower control risk assessment, determining the extent of reduction in tests of the key control activity to support the assessment is a matter of auditor judgment. Likewise, judgment is also necessary in determining the extent of tests if the auditor deems that a control activity and an entity-level control should both be tested to support a planned control assessment. In making these determinations, the auditor would normally consider factor such as:

- How directly the related entity-level control contributes to the achievement of the control objective related to the assertion.
- The evidence obtained during the performance of risk assessment procedures and its persuasiveness.
- The planned control risk assessment desired.

<u>Example Using Evidence from Entity-level Controls.</u> Assume that a key control over the accuracy of accounts receivable is the daily review and resolution of a suspense account that represents cash collections that could not be posted to the receivable subsidiary ledger due to missing or incorrect remittance information. For each day, the collection resolution clerk (a) reviews the suspense account, (b) investigates outstanding items, (c) makes appropriate corrections resulting in the clearing of the suspense account and posting to the subsidiary ledger (or reclassification of the receipt), and (d) documents the work performed. A monitoring control also exists where, at the end of each month, the cash collections controller ensures that the daily resolution control operates by reviewing the documentation of the daily resolution activity. The controller takes appropriate corrective action if the control was not properly and completely performed and documents the results of the review. The auditor has a planned expectation of operating effectiveness of the activity-level control and wishes to support a low control risk assessment.

Assessing Control Risk at Reduced Levels Based on Risk Assessment Procedures. Many of the procedures commonly used in the risk assessment process to gain an understanding of internal control (such as inquiry, observation and inspection, and walkthroughs) also may provide evidence about the controls' operating effectiveness. SAS No. 110 (AU 318.27) states the following:

> Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls, and consequently, serve as tests of controls.

According to SAS No. 109 (AU 314.56), obtaining an understanding of controls is not sufficient to serve as testing operating effectiveness unless there are effective IT general controls and some automation that provides for the consistent application of the control. In other words, tests of controls need to be performed to support operating effectiveness. And those tests need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, there may be circumstances when procedures performed to understand the design and implementation of controls may support a reduced control risk assessment even in the absence of automation. The following examples illustrate the use of risk assessment procedures to support a reduced control risk assessment.

Some procedures performed to obtain an understanding of the control environment, such as inquiring about management's use of budgets, observation of management's comparison of actual and budgeted expenses, and inspection of reports about the investigation of and response to variances from the budget throughout the period under audit, may not only provide evidence about the design and use of budgets as a control, but also may provide evidence that the budget policies and procedures are operating effectively enough (that is, applied at a sufficiently detailed level) to prevent or detect misstatements in the financial reporting of expenses. This evidence may support a reduced control risk assessment for certain assertions related to expenses based on the auditor's consideration of whether the audit evidence provided by the procedures is sufficient.

As another example, in gaining an understanding of the monitoring component, the auditor might review reconciliations to determine whether they have annotations documenting that they were reviewed. That would constitute a test of that control during the period under audit. Similarly, procedures performed to gain an understanding of the information and communication component, such as questioning employees involved in accounting and computer processing and examining source documents and computer output at various stages in the accounting process throughout the period under audit, might constitute tests of the information and communication control component.

As a final example, because of the inherent consistency of IT processing, performing risk assessment procedures to gain an understanding of an automated control (that is, to determine whether the control has been implemented) may serve as a test of the control's operating effectiveness, depending on the auditor's assessment and testing of IT general controls such as computer security and program change controls.

What does all of this mean for the auditor's control risk assessment? The auditing standards do not specify the amount of audit evidence needed to assess control risk at less than high. The quantity and persuasiveness of audit evidence that is sufficient to support a specific risk assessment is a matter of professional judgment. However, best practices indicate it may be possible to support a control risk assessment of moderate based on procedures performed to evaluate the design of controls and determine that they have been implemented. For example, a walkthrough can serve as a test of controls and, in some cases, along with other risk assessment procedures that serve as tests of controls, can provide a valid basis for assessing control risk at less than high. However, the authors believe such tests will not support a control risk assessment of low unless there is some automation that provides for the consistent application of the control. Consideration should be given to the nature of the control and overall control objective, the frequency of its operation, and whether sufficient evidence has been obtained about how the control was applied throughout the period under audit when determining whether risk assessment procedures alone are sufficient to support a reduced control risk assessment.

Effect of the Control Risk Assessment on Substantive Procedures

Lesson 1 discusses substantive procedures. All else being equal, the lower the assessed level of control risk with respect to an audit area, the less rigorous audit procedures can be without increasing audit risk for the area. This means that the extent of substantive procedures can be reduced without increasing audit risk. The assessed risk of material misstatement affects the auditor's response. If control risk and the risk of material misstatement are assessed as high for a particular audit area or assertion, generally the auditor would document on the "Risk Assessment Summary Form" the plan to select procedures from the Extended Procedures (Procedures for Additional Assurance) section of the audit program to obtain additional assurance and address the higher risk level. If, on the other hand, risk of material misstatement is assessed as moderate, for example, because the audit evidence supports a reduced control risk assessment, the auditor might decide (and document on "Risk Assessment Summary Form") that the Basic Procedures section of the audit program will suffice.

When the control risk assessment (and, consequently, the combined risk of material misstatement) is reduced by performing tests of controls, reductions of the extent of substantive procedures might include the following:

- Applying an analytical procedure as a substantive procedure instead of a test of details.
- Using a less effective analytical procedure, such as one based on data developed by the client internally rather than on data developed from external sources.
- Examining fewer items in a test of details, such as using a smaller sample size if sampling is used.
- Sending fewer confirmations.

The practical implication of being able to use less rigorous audit procedures or reduce the extent of substantive procedures is increased audit efficiency.

Note that although a lowered control risk assessment may be a basis for reducing the extent of substantive procedures, substantive procedures cannot be omitted entirely where material misstatements could exist. SAS No. 110 (AU 318.51) states the following:

> Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control, including management override, and even effective internal controls generally reduce, but do not eliminate, the risk of material misstatement.

Using the PPC Approach. Using the "Risk Assessment Summary Form," the auditor selects an audit approach consisting of Limited Procedures, Basic Procedures, or Extended Procedures (Procedures for Additional Assurance) based on the assessed risk of material misstatement at the relevant assertion level. Reductions in the control risk assessment (and, consequently, in the assessed risk of material misstatement) may enable the auditor to select an audit approach that is effective and more efficient to respond to the assessed level of risk. How much reduction in the control risk assessment is needed, however, to enable the auditor to choose Limited Procedures rather than Basic Procedures or Basic Procedures rather than Extended Procedures? The answer is a matter of professional judgment, but the authors have developed some guidelines in Exhibit 2-5 that auditors may find useful. As indicated in Exhibit 2-5, a control risk assessment of moderate ordinarily does not affect the choice of audit approach between Limited, Basic, or Extended Procedures. However, it may allow the auditor to alter the extent of substantive procedures within a given audit approach. Only a control risk assessment of low can ordinarily change the auditor's chosen approach from Extended Procedures to Basic Procedures.

Exhibit 2-5

Guidelines for Reducing Substantive Procedures Based on a Reduced Control Risk Assessment

Characteristics of the Audit Area	Inherent Risk	Control Risk	Risk of Material Misstatement	Comments
Significant audit area that does *not* contain fraud risks or other significant risks.	High	High or Moderate	High	When inherent risk is high with no fraud or other significant risks, the Extended Procedures (Procedures for Additional Assurance) approach is recommended unless the control risk assessment can be reduced to low. A control risk assessment of low, which reduces the overall risk of material misstatement to moderate, may permit the auditor to respond using Basic Procedures.
		Low	Moderate	
Significant audit area that does *not* contain fraud risks or other significant risks.	Moderate	High	Moderate	Regardless of the control risk assessment, best practices indicate that the auditor should perform at least the Basic Procedures for this level of inherent risk in significant audit areas with no fraud risks or other significant risks.
		Moderate or Low	Low	
Significant audit area that contains fraud risks or other significant risks.	High	High or Moderate	High	Regardless of the control risk assessment, the best practices indicate that auditors should perform Extended Procedures (Procedures for Additional Assurance) for audit areas or assertions that contain fraud risks or other significant risks. That is, even if the overall risk of material misstatement could be reduced to moderate by testing controls, tests of controls or extended analytical procedures are ordinarily still necessary to respond to fraud risks or other significant risks. (Fraud risks and other significant risks ordinarily involve high inherent risk.)
		Low	Moderate	

*   *   *

TESTS OF CONTROLS AND THE CONTROL RISK ASSESSMENT—DOCUMENTATION

The auditor should prepare documentation of the following matters related to tests of controls: (SAS No. 110, AU 318.77)

- *The nature, timing, and extent of further audit procedures.* According to SAS No. 110 (AU 318.11), further audit procedures include tests of controls and substantive procedures. Therefore, the nature, timing, and extent of tests of controls should be documented.

- *The linkage of further audit procedures (tests of controls) with the assessed risks (control risk assessment) at the relevant assertion level.*

- *The results of the audit procedures.* Because tests of controls are further audit procedures, the results of tests of controls should be documented.

- *The conclusions reached with respect to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit.*

SAS No. 110 notes that the manner in which these matters are documented is based on professional judgment and that SAS No. 103 (AU 339), *Audit Documentation*, provides standards and guidance on documentation.

SAS No. 103 requires documentation of the identifying characteristics of specific items tested. This requirement specifically includes tests of the operating effectiveness of controls involving inspection of documents. SAS No. 103 also provides examples for documenting the identifying characteristics of inquiry and observation procedures.

For inspection of documents, the authors believe items tested can be identified by listing the items; by including a detail schedule in the workpapers on which the items are identified; or by documenting in the workpapers the source and selection criteria and other information necessary to identify the items selected such as the initial item selected using systematic selection. For inquiry and observation procedures, the identifying characteristics may be documented as follows:

- For inquiries, document the dates of the inquiries, the names and job functions of client personnel queried, and the inquiry that was made.

- For observations, document the matter observed, the individuals involved and their responsibilities, and where and when the observation took place.

SAS No. 108 (AU 311.21) indicates that the audit plan should include 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. Because tests of controls are further audit procedures, planned tests of controls should be documented as part of the detailed audit plan.

Practice Aids

The following practice aids are provided to document the matters that relate to tests of controls.

- "Test of Controls Form."

- "Activity and Entity-level Control Forms."

These forms are discussed in the following paragraphs. Alternatively, auditors can document their tests of controls in a memo.

"Test of Controls Form." The "Test of Controls Form" documents controls tested and links the related assertion(s), testing procedures performed, results of the test (the conclusion based on the tests about whether the controls are operating effectively), and the effect of the test results on the control risk assessment documented on the "Risk Assessment Summary Form," (that is, whether the test results confirm the planned control risk assessment or support a different control risk assessment) and on substantive procedures. A revised control risk assessment can be documented by revising the "Risk Assessment Summary Form." SAS No. 110 states that tests of controls may be rotated over a three year cycle, and the SAS provides guidelines for rotating tests. The "Test of Controls Form" provides space for the auditor to document that a control was tested in a prior year and to add comments about the consideration of whether conditions relevant to the control have changed. The form can be carried forward for three years.

"Activity and Entity-level Control Forms." The "Activity and Entity-level Control Forms" may be used in identifying controls to test when the auditor has decided that it is necessary or beneficial to test controls but has not identified specific controls to test. The forms help the auditor decide which controls to test by identifying the assertions relevant to each control activity. The forms provide controls for each COSO component of internal control, including those at the entity-level.

Memo. The auditor may choose to document the test of controls and resulting control risk assessment in memo form rather than using the preceding practice aids. A memo would describe the control activity tested, the assertion and audit area to which the control relates, the nature, timing, and extent of the procedure used to test the control's operating effectiveness, and the results of the test. The control risk assessment based on the test would be documented, as would the effect of the assessment on planned substantive procedures.

SELF-STUDY QUIZ

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

34. Application controls include which of the following?

    a. Controls over network and data center operations.

    b. Reporting financial data using IT.

    c. Acquisition, change, and maintenance of system software.

35. Of the following statements, which one is accurate regarding detecting deviations from prescribed procedures through test of controls?

    a. An auditor should assume that an instance of fraud or error is an isolated instance.

    b. Controls should be evaluated individually.

    c. An isolated deviation or minor weakness generally means that control risk is high.

    d. The ineffective operation of an indirect control might cause a deviation in a control activity.

36. Substantive procedures may result in all of the following **except**:

    a. The detection of a material misstatement which should be regarded as a minor deficiency and not an indication that a material weakness in internal control exists.

    b. The need to reevaluate the prior assessment of control risk.

    c. Additional evidence that supports the auditor's conclusion about the operating effectiveness of controls.

37. June is an auditor considering reperformance evidence in assessing control risk. Which of the following would be a common way for June to use such evidence in her control risk assessment?

    a. Assessing the effectiveness of controls that do not leave a documentary trail of their performance.

    b. Assessing operating effectiveness, especially for controls relating to reconciliations and other documented routines.

    c. Evaluating the design and implementation of controls.

    d. Providing evidence about operating effectiveness, especially when used with document inspection tests.

38. For what type of evidence is persuasiveness sometimes limited when assessing control risk?

    a. Walkthroughs.

    b. Reperformance.

    c. Inspection of client documents.

    d. Inquiry and observation.

39. Which of the following statements regarding the source of the evidence about controls is most accurate?

    a. Evidence obtained from internally produced documents, records, or reports is more persuasive than evidence from ones produced externally.

    b. Evidence obtained indirectly by the auditor generally provides more assurance than evidence obtained directly.

    c. The stronger the control environment, the more persuasive is evidence provided by observation.

    d. Evidence obtained by observation is always superior to evidence obtained by inquiry.

40. Which of the following is most accurate regarding assessing control risk at a reduced level based on risk assessment procedures?

    a. A walkthrough can serve as a test of controls.

    b. IT processing should not be used to serve as a test of the control's operating effectiveness.

    c. Auditors should not rely on reconciliations to determine if they have annotations documenting that they were reviewed.

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.)**

34. Application controls include which of the following? **(Page 94)**

    a. Controls over network and data center operations. [This answer is incorrect. Controls over network and data center operations are classified as *general* controls because they relate to many applications.]

    b. Reporting financial data using IT. [This answer is correct. Application controls relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data and help ensure that transactions occurred, are authorized, and are accurately and completely recorded and processed.]

    c. Acquisition, change, and maintenance of system software. [This answer is incorrect. System software acquisition, change, and maintenance are examples of *general* controls, because their purpose is to support the effective functioning of application controls by enduring the proper operation of information systems.]

35. Of the following statements, which one is accurate regarding detecting deviations from prescribed procedures through test of controls? **(Page 99)**

    a. An auditor should assume that an instance of fraud or error is an isolated instance. [This answer is incorrect. According to SAS No. 110, an auditor should *not* assume that an instance of fraud or error is an isolated instance. Careful analysis should be made to determine how it may impact the assessed risk of material misstatement.]

    b. Controls should be evaluated individually. [This answer is incorrect. According to the Standards, controls should be evaluated as a group rather than individually because an effectively operating control might compensate for one that is operating ineffectively.]

    c. An isolated deviation or minor weakness generally means that control risk is high. [This answer is incorrect. According to SAS No. 110, the auditor should not assume that an isolated deviation or minor weakness necessarily means that control risk is high. The auditor needs to understand the deviation by making inquiries or performing other tests related to indirect controls.]

    d. The ineffective operation of an indirect control might cause a deviation in a control activity. [This answer is correct. In some instances, a deviation in a control activity might result from the ineffective operation of an indirect control, for example, related to the control environment or IT general controls per SAS No. 110.]

36. Substantive procedures may result in all of the following **except**: **(Page 73)**

    a. The detection of a material misstatement which should be regarded as a minor deficiency and not an indication that a material weakness in internal control exists. [This answer is correct. A material misstatement detected through the performance of substantive procedures should be regarded, at a minimum, as a significant deficiency and a strong indicator that a material weakness in internal control exists and should be communicated to management and those responsible for governance, as indicated in SAS No. 110.]

    b. The need to reevaluate the prior assessment of control risk. [This answer is incorrect. According to SAS No. 110, substantive procedures may provide additional evidence that creates the need to reevaluate the prior assessment of control risk.]

    c. Additional evidence that supports the auditor's conclusion about the operating effectiveness of controls. [This answer is incorrect. One of the results of substantive procedures is that they may provide additional evidence that supports the auditor's conclusion about the operating effectiveness of controls.]

37. June is an auditor considering reperformance evidence in assessing control risk. Which of the following would be a common way for June to use such evidence in her control risk assessment? **(Page 102)**

   a. Assessing the effectiveness of controls that do not leave a documentary trail of their performance. [This answer is incorrect. Best practices indicate that *inquiry and observation* evidence is especially useful in assessing the effectiveness of controls that do not leave a documentary trail of their performance.]

   b. Assessing operating effectiveness, especially for controls relating to reconciliations and other documented routines. [This answer is incorrect. Best practices indicate that *inspection of client documents* (including reconciliations and other routines) can provide strong evidence about operating effectiveness, especially for controls relating to reconciliations and other documented routines.]

   c. Evaluating the design and implementation of controls. [This answer is incorrect. Best practices indicate that evidence from *walkthroughs* may be useful in evaluating the design and implementation of controls.]

   d. Providing evidence about operating effectiveness, especially when used with document inspection tests. [This answer is correct. Reperformance evidence usually provides substantive audit evidence about the transaction as well as about the control activity. For example, the auditor will obtain evidence that the transaction is recorded in the proper account at the proper amount as well as that it was properly approved.]

38. For what type of evidence is persuasiveness sometimes limited when assessing control risk? **(Page 102)**

   a. Walkthroughs. [This answer is incorrect. When the type of evidence being considered in assessing control risk is walkthroughs, the limitation is that the degree of persuasiveness depends on the extent of other evidence obtained about operating effectiveness.]

   b. Reperformance. [This answer is incorrect. The limitation on reperformance evidence is similar to the limitation on evidence in inspection of client documents but the other limitation on reperformance is that it can also be very time-consuming.]

   c. Inspection of client documents. [This answer is incorrect. The limitation associated with evidence involving inspection of client documents is that the degree of persuasiveness depends on the extent of procedures and is primarily used to test controls that leave a documentary trail of their performance.]

   d. Inquiry and observation. [This answer is correct. The limitation associated with evidence involving inquiry and observation is that persuasiveness is sometimes limited because the evidence may only apply to the period of time the auditor is present.]

39. Which of the following statements regarding the source of the evidence about controls is most accurate? **(Page 104)**

   a. Evidence obtained from internally produced documents, records, or reports is more persuasive than evidence from ones produced externally. [This answer is incorrect. Evidence obtained from *externally* produced documents, records, or reports is more persuasive than evidence from those produced internally because those produced internally may have a greater potential for being biased.]

   b. Evidence obtained indirectly by the auditor generally provides more assurance than evidence obtained directly. [This answer is incorrect. Evidence about controls obtained *directly* by the auditor generally provides more assurance than evidence obtained indirectly. Direct observation by the auditor of a control procedure being performed, provides more assurance than the auditor being told how the control procedure is performed.]

   c. The stronger the control environment, the more persuasive is evidence provided by observation. [This answer is correct. Generally, the stronger the control environment is, the more likely it is that the observed activity is performed consistently at times when it is not observed. Thus, the stronger the control environment is, the more persuasive is evidence provided by observation.]

d. Evidence obtained by observation is always superior to evidence obtained by inquiry. [This answer is incorrect. Evidence obtained by observation is generally, but not always, superior to inquiry due to the fact that the observed control activity might not be performed in the same manner when the auditor is not present.]

40. Which of the following is most accurate regarding assessing control risk at a reduced level based on risk assessment procedures? **(Page 104)**

a. A walkthrough can serve as a test of controls. [This answer is correct. The quantity and persuasiveness of audit evidence that is sufficient to support a specific risk assessment is a matter of professional judgment. However, best practices indicate it may be possible to support a control risk assessment of moderate based on procedures performed to evaluate the design of controls and determine that they have been implemented. For example, a walkthrough can serve as a test of controls and, in some cases, along with other risk assessment procedures that serve as tests of controls, can provide a valid basis for assessing control risk at less than high.]

b. IT processing should not be used to serve as a test of the control's operating effectiveness. [This answer is incorrect. According to SAS No. 109, because of the inherent consistency of IT processing, performing risk assessment procedures to gain an understanding of an automated control may serve as a test of the control's operating effectiveness, depending on the auditor's assessment and testing of IT general controls such as computer security and program change controls.]

c. Auditors should not rely on reconciliations to determine if they have annotations documenting that they were reviewed. [This answer is incorrect. According to SAS No. 109, in gaining an understanding of the monitoring component, the auditor might review reconciliations to determine whether they have annotations documenting that they were reviewed. That would constitute a test of that controls during the period under audit.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (ALGTG101)

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

19. An auditor determines whether to test controls for significant assertions in each audit area based on which of the following?

    a. Initial audit strategy.

    b. Preliminary assessment of the risk of material misstatement.

    c. Feasibility of performing tests.

    d. Audit efficiency considerations.

20. Brett is engaged in an audit of Eastern University. After gaining an understanding of the entity and its environment, including its internal control, Brett should first consider which of the following?

    a. The results of the understanding of internal control when making a decision about the feasibility or efficiency of testing controls.

    b. If the amount and persuasiveness of available evidence would be adequate to support the planned reduced control risk assessment.

    c. The nature, timing, and extent of any planned substantive procedures.

    d. The materiality and inherent risk associated to specific audit areas when determining the appropriate audit response.

21. An auditor should consider which of the following when deciding whether to test controls?

    a. If the amount of obtainable evidence is enough to maintain the planned reduced control risk assessment.

    b. If the tests of controls are efficient.

    c. The cost of testing the controls.

    d. The effective functioning of general controls.

22. Tests of controls are efficient when a number of circumstances exist for a given audit area. Which of the following is **not** one of those circumstances?

    a. Tim is auditing LakeView Junior College and notices repeated transactions that are similar within each of the classes.

    b. Sandy is auditing Northeastern University and finds numerous simplistic transactions.

    c. Amos is conducting an audit of the City of Refugio and discovers that most of the transactions are regularly processed in information systems with well-designed control activities.

    d. Simon is conducting an audit of the City of Cuero and discovers the volume of transactions is comparatively low.

23. Liz is conducting an audit of Eastland Junior college. Liz has to determine which controls to test. Which of the following would be the most effective and efficient way to determine which controls to test?

    a. Step-by-step.

    b. Top-down.

    c. Sampling.

    d. Do not select this answer choice.

24. Which of the actions below is an example of a process rather than a control?

    a. Invoice coding by the accounts payable clerk and input to the payable system.

    b. Supervisory review of the amounts input and account coding.

    c. Use of programmed edit routines that detect discrepancies between input amounts and underlying purchase orders.

    d. Use of programmed restrictions in the accounts payable limiting accounts eligible for coding.

25. Determining whether to test complementary controls requires auditor's judgment. Which of the following factors that an auditor might consider when making such decisions is most accurate?

    a. The need for audit evidence regarding the complementary control will increase as the degree of significance increases.

    b. The degree of audit evidence needed regarding complementary controls should decrease if the auditor requires a larger degree of reliability from the tests of operating effectiveness.

    c. The auditor should not perform risk assessment procedures in understanding direct control to obtain evidence regarding operating effectiveness of complementary controls.

    d. Do not select this answer choice.

26. Evidence regarding operating effectiveness may be derived from a wide array of sources including which of the following?

    a. Type 1 SAS No. 70 Reports.

    b. Prior audits.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

27. Which of the following is true regarding inquiry and observation?

    a. They are rarely used in the risk assessment phase of the audit.

    b. They are not used to test controls that do not produce documentary evidence of performance.

    c. Observation is many times supplemented by inquiry.

    d. They do not make it possible for the auditor to gain evidence about the controls' operating effectiveness.

28. A(n) __________ is an example of a source document.

    a. Bill of lading.

    b. Shipping log.

    c. Internal auditor's report.

    d. Receiving log.

29. Examples of efficient tests of controls may include review of reconciliations and similar bookkeeping routines. They may include review of any of the following **except**:

    a. Audit sampling.

    b. Accounting for the numerical sequence of documents.

    c. Follow-up of unmatched items.

    d. Reconciliation of related nonaccounting data.

30. All of the following are considered evidence included in testing controls **except**:

    a. How controls are applied at significant times during the period under audit.

    b. The experience level of the employees.

    c. Who applied the controls.

    d. The consistency of the application.

31. SAS No. 110 indicates that, generally, the auditor should consider using audit sampling for tests of controls in which of the following circumstances?

    a. Examining actions of directors to assess their effectiveness.

    b. The control is applied on a transaction basis.

    c. Tests of automated application controls when effective IT general controls are present.

    d. Analysis of the effectiveness of security and access controls.

32. Regarding efficiency opportunities in testing controls, what is the first thing to consider when deciding how much attention to give to controls?

    a. Whether substantive testing of the account balance or transaction class may provide evidence about the control risk related to the account or transaction class.

    b. Evidence provided by tests of controls performed in prior audits.

    c. Whether the understanding of controls obtained indicates that controls appear to be suitably designed and implemented.

    d. The materiality and inherent risk for the audit area.

33. Which of the following is an example of a factor Eddie Auditor should consider in determining the need for a specialist to test complex computer controls?

    a. Eddie reviews the entity's use of the most current technologies.

    b. Eddie determines the entity's involvement in e-commerce.

c. Eddie determines that the entity's personnel have extensive remote access to computer programs.

d. Eddie discovers that significant audit evidence is available only in electronic form.

34. Which of the following procedures might a computer specialist perform involving complex computer systems?

a. Observe security software logs.

b. Monitor the operation of controls.

c. Monitor physical access to program and data.

d. Obtain authorized access to programs using improper passwords.

35. Obtaining more audit evidence will be required for an assessment of which of the following?

a. Low control risk.

b. Moderate control risk.

c. High control risk.

d. Do not select this answer choice.

36. Based on the results of the tests of controls concerning operating effectiveness, the auditor should do all of the following **except**:

a. Determine whether test results provide an appropriate basis for reliance on controls.

b. Rely on controls maintained by a service organization with a Type 1 SAS 70 report.

c. Decide if additional tests of controls are necessary.

d. Consider using substantive procedures to address the potential risks of misstatement.

37. Review of cash account reconciliations is an example of controls being tested with which type of evidence?

a. Inquiry and observation.

b. Inspection of client documents.

c. Prior audits.

d. Walkthroughs.

38. Reductions of the extent of substantive procedures might include which of the following when the control risk assessment and, thus, the combined risk of material misstatement are reduced by performing tests of controls?

a. Applying an analytical procedure as a substantive procedure instead of a test of details.

b. Using a more effective analytical procedure, such as one based on data developed from external sources.

c. Examining more items in a test of details, such as using a larger sample size if sampling is used.

d. Sending more accounts receivable confirmations or observing a physical inventory at more locations.

39. What is the level of inherent risk when significant audit areas do not contain fraud or other significant risks?

a. Moderate or high.

b. Moderate.

c. Moderate to low.

d. High.

40. If inherent risk is high and there is no fraud or other significant risks, the Extended Procedures method is recommended unless the control risk assessment can be reduced to which of the following?

a. Low.

b. Moderate.

c. Moderate to high.

d. Do not select this answer choice.

GLOSSARY

Analytical Procedures: Evaluations of financial information made by a study and comparison of plausible relationships among both financial and nonfinancial data.

Appropriateness: The measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.

Comprehensive Annual Financial Report (CAFR): GASB Statement No. 34 recommends that governments publish a Comprehensive Annual Financial Report. 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. The GASB's website includes numerous actual CAFRs categorized by type of government. The CAFRs can be accessed at **www.gasb.org/repmodel/**.

Opinion Unit: The auditor's consideration of whether tests of controls are appropriate in the audit of a governmental entity is done in the context of opinion units. If the internal control for a transaction cycle is handled by the same system regardless of where the transactions and balances are reported in the financial statements, the auditor's consideration of internal control and assessment of control risk for that system would apply equally to all affected opinion units, even if transactions and balances reported in an individual opinion unit are not included in a test of controls.

Overall Review Analytical Procedures: Used in the final review stage of the audit.

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.

Precision: The term used to describe the degree of accuracy of the expectation developed by the auditor to the actual amount.

Preliminary (Planning) Analytical Procedures: Used to enhance the auditor's understanding of the client's business and assist in assessing areas of specific risk of misstatement by identifying unexpected relationships among account balances or the absence of expected relationships.

SAS No. 99, *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.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*: Addresses audit procedures that are responsive to risks at the relevant assertion level.

Significant Risks: Risks that require special audit attention.

Single Audit: A rigorous, organization-wide audit or examination of an entity that expends $500,000 or more of Federal assistance (commonly known as Federal funds, Federal grants, or Federal awards) received for its operations.

Substantive Analytical Procedures: Used to obtain audit evidence about potential misstatements.

Sufficiency: The measure of the quantity of audit evidence.

Tests of Balances: 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: Tests of the processing of individual transactions by inspection of the documents and accounting records involved in processing, e.g., inspecting supporting documents for a cash disbursement.

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COMPANION TO PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS

COURSE 2

RISK ASSESSMENT PROCEDURES AND PLANNING (ALGTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the AICPA's Audit and Accounting Guide for State and Local Governments as well as material covering the single audit concept. The first lesson covers *general* planning decisions. The second lesson discusses how the performance of risk assessment procedures can help the auditor with important planning decisions and judgments.

PUBLICATION/REVISION DATE: March 2010

RECOMMENDED FOR: Users of *PPC's Guide to Audits of Local Governments*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Yellow Book CPE Credit: This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing 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 **March 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Planning the Audit of a Governmental Unit

Completion of this lesson will enable you to:

- Identify the authoritative literature referenced when planning an audit of a governmental unit.
- Determine risk assessment procedures prior to the audit of a governmental unit.
- Identify the industry, regulatory and external factors that are unique to a governmental entity and its environment as they relate to the audit process.
- Recognize the components of internal control.
- Identify and document the control environment of a governmental unit.

Lesson 2—Documentation of the Audit Plan

Completion of this lesson will enable you to:

- Determine materiality at the governmental unit, item and financial statement levels.
- Describe an overall audit strategy.
- Identify the factors unique to governmental units when considering misstatements caused by fraud.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
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ALGTG102 Self-study CPE
36786 Treasury Center
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ADMINISTRATIVE POLICIES:

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

Lesson 1: Planning the Audit of a Governmental Unit

INTRODUCTION

The focus of this course is *general* planning decisions. General or preliminary planning should be distinguished from detailed planning of audit programs. Preliminary planning includes deciding on an overall strategy for the audit, obtaining an understanding of the entity and its environment, including its internal control, making an initial assessment of audit risk and materiality, and deciding on the overall timing of the engagement.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the authoritative literature referenced when planning an audit of a governmental unit.
- Determine risk assessment procedures prior to the audit of a governmental unit.
- Identify the industry, regulatory and external factors that are unique to a governmental entity and its environment as they relate to the audit process.
- Recognize the components of internal control.
- Identify and document the control environment of a governmental unit.

Authoritative Literature

The following standards establish key requirements and provide guidance that affect preliminary audit planning as follows:

a. SAS No. 107 (AU 312), *Audit Risk and Materiality in Conducting an Audit*, requires auditors to consider audit risk and determine and document materiality for the financial statements as a whole, as well as tolerable misstatement, when planning the audit.

b. SAS No. 108 (AU 311), *Planning and Supervision*, addresses planning the audit, including topics such as establishing an overall audit strategy, developing the audit plan, determining the extent of involvement of professionals with specialized skills, supervision of assistants, communication with management and those charged with governance, and considerations in initial audits.

c. SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes the level of understanding of the entity and its environment, including its internal control, the auditor should obtain for preliminary planning purposes. That standard also addresses risk assessment procedures and assessing the risks of material misstatement.

d. SAS No. 110 (AU 318), *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, explains the requirements for establishing the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.

Aspects of the following standards also affect audit planning:

a. SAS No. 54 (AU 317), *Illegal Acts by Clients*, indicates that the auditor's responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for other errors and fraud. For other illegal acts, the auditor, in conducting the audit, remains aware of their possibility but does not design the audit specifically to detect them.

b. SAS No. 56 (AU 329), *Analytical Procedures*, requires the auditor to apply analytical procedures during the planning stage (and the overall review stage) of the audit.

c. SAS No. 65 (AU 322), *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.

d. SAS No. 70 (AU 324), *Service Organizations*, provides guidance on obtaining an understanding of internal control of a client that uses a service organization.

e. SAS No. 73 (AU 336), *Using the Work of a Specialist*, provides guidance when the auditor plans to use the work of a specialist hired by the client or the auditor. It does not apply to a specialist employed by the auditor's firm who participates in the audit.

f. SAS No. 99 (AU 316), *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.

g. SAS No. 117 (AU 801), *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.

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

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

j. AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide), provides guidance on performing Yellow Book audits and Single Audits.

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

The Auditing Standards Board is completing its large-scale project to redraft and revise all existing U.S. auditing standards to improve clarity and to converge with the International Standards on Auditing (ISAs). The ASB anticipates that the redrafted and clarified SASs, except those that address current issues, will be effective for audits of financial statements no earlier than for periods beginning on or after December 15, 2010. Standards that address current issues could have earlier effective dates.

Objectives of Audit Planning

The first standard of fieldwork states that "the auditor must adequately plan the work and must properly supervise any assistants" (AU 150.02). According to SAS No. 108 (AU 311.02), *Planning and Supervision*, audit planning involves "developing an overall audit strategy for the expected conduct, organization, and staffing of the audit." 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. 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.

An overriding objective throughout the planning process is the identification of risks that should be considered and an assessment of whether the risks could result in material misstatement of the financial statements. According to SAS No. 108 (AU 311), obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. Auditors must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditors' understanding of the entity and its environment, including its internal control.

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.

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 is required to perform all of these procedures when planning the audit.

The auditor's consideration of fraud required by SAS No. 99, *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 SAS No. 99 are addressed at relevant points throughout this course.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control. The auditor obtains information about the following:

a. Industry, regulatory, and other external factors.

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

c. Objectives and strategies and the 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. 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 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 financial statement level. • Materiality for particular items of lesser amounts. • Risks of material misstatement at the financial statement level. • Overall audit strategy. <u>Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level:</u> • Tolerable misstatement. • 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. This approach is presented in Exhibit 1-2.

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 tolerable misstatement, are often performed concurrently. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances, but should occur relatively early in planning, and it is not required to occur in any particular sequence.

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 preliminary audit strategy.

5. Determine the nature, timing, and extent of risk assessment procedures and perform the procedures.

6. Determine the materiality level for the financial statements taken as a whole (preliminary planning materiality) and materiality for particular items of lesser amounts.

7. Perform preliminary analytical procedures (a risk assessment procedure).

8. Hold a discussion among the engagement team.

9. Identify fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks of material misstatement.

10. Assess audit risk at the overall financial statement level.

11. Complete the overall audit strategy, including overall responses at the financial statement level.

Detailed Audit Planning at the Relevant Assertion Level for Account Balances, Transaction Classes, and Disclosures

12. Determine tolerable misstatement (often in conjunction with Step 6).

13. Assess audit risk in relation to relevant assertions for transactions classes, account balances, and disclosures.

14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

* * *

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 taken as whole, that determination must be made for the financial statements of each opinion unit. Also, where item 10 refers to assessing audit risk at the overall financial statement level, that assessment, too, should consider each opinion unit separately.

The auditor also should 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. 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 must consider the different processes and internal control over that additional information. SLG, paragraph 4.08, 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 should always be 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 should 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.

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 legislators), 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.

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

- Board meetings are usually open to the public and,
  - Senior management and the governing board are subject to political influences because they are elected officials or report to elected officials.
  - Board and management decisions and 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 board 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 structure of governments in general, and certain functions specifically, may create an environment that is inflexible or resistant to change. For example:
  - Employee benefits and a 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.
- Financial statements may have to conform to accounting and financial reporting requirements established by another government with financial reporting oversight responsibilities.

Organization of This Lesson

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 tolerable misstatement 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 14 in Exhibit 1-2.

The organization of this lesson is as follows:

- Risk assessment and other planning procedures.
- The understanding of the governmental unit and its environment (excluding internal control).

- The understanding of internal control.
- The understanding of entity-level controls, including the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring.
- The understanding of activity-level controls, including the financial reporting system, IT environment and general computer controls, 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 integrates with the overall risk assessment process.
- The auditor's consideration of whether to perform substantive procedures before the balance sheet date.
- General planning procedures and forms.
- Planning the audit time estimate and documenting the time spent performing the audit.

Throughout this lesson, an overriding objective is the identification of risks that should be assessed as to whether they could result in a material misstatement of the financial statements.

SELF-STUDY QUIZ

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

1. What guidance does SAS No. 108 provide?

   a. Planning the audit.

   b. Risk assessment procedures.

   c. Considering audit risk.

   d. Determining materiality for the financial statements as a whole.

2. An auditor would establish guidelines to understand the entity and its environment by referencing which of the following pronouncements?

   a. SAS No. 107.

   b. SAS No. 108.

   c. SAS No. 109.

   d. SAS No. 110.

3. The nature, timing and extent of the audit plan varies with which of the following?

   a. The auditors' understanding of the entity and its environment.

   b. The need to perform risk assessment.

   c. The risk assessment procedures performed after the audit.

   d. The sequence of risk assessment procedures performed.

SELF-STUDY ANSWERS

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

1. What guidance does SAS No. 108 provide? **(Page 127)**

   a. Planning the audit. [This answer is correct. SAS No. 108 addresses planning the audit, including topics such as establishing an overall audit strategy, developing the audit plan, determining the extent of involvement of professionals with specialized skills, supervision of assistants, communication with management and those charged with governance, and considerations in initial audits.]

   b. Risk assessment procedures. [This answer is incorrect. Risk assessment is addressed in SAS No. 107, 109 and 110.]

   c. Considering audit risk. [This answer is incorrect. Audit risk is addressed in SAS No. 107.]

   d. Determining materiality for the financial statements as a whole. [This answer is incorrect. Materiality for the financial statements as a whole is addressed in SAS No. 107.]

2. An auditor would establish guidelines to understand the entity and its environment by referencing which of the following pronouncements? **(Page 127)**

   a. SAS No. 107. [This answer is incorrect. SAS No. 107 addresses audit risk and materiality in conducting an audit.]

   b. SAS No. 108. [This answer is incorrect. SAS No. 108 addresses planning and supervision.]

   c. SAS No. 109. [This answer is correct. SAS No. 109 addresses understanding the entity and its environment and assessing the risks of material misstatement.]

   d. SAS No. 110. [This answer is incorrect. SAS No. 110 addresses performing audit procedures in response to assessed risks and evaluating the audit evidence obtained.]

3. The nature, timing and extent of the audit plan varies with which of the following? **(Page 129)**

   a. The auditors' understanding of the entity and its environment. [This answer is correct. The nature, timing and extent of audit plan varies with the size and complexity of the entity and the auditor's understanding of the entity and its environment.]

   b. The need to perform risk assessment. [This answer is incorrect. Audit planning will always include a risk assessment process.]

   c. The risk assessment procedures performed after the audit. [This answer is incorrect. Risk assessment should be performed before and during the audit.]

   d. The sequence of risk assessment procedures performed. [This answer is incorrect. The sequence of risk assessment procedures and other audit plan procedures varies as a function of the auditors experience with the client and continues throughout the audit.]

RISK ASSESSMENT AND PLANNING PROCEDURES

As stated previously, an overriding objective throughout the planning process is the identification of risks that should be assessed as to whether they could result in material misstatement of the financial statements. SAS No. 106 (AU 326.21) clearly indicates the role of the risk assessment procedures within this process as follows:

> The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.

The auditor needs to consider opinion units in the audit, including during the planning and risk assessment activities. SLG, Paragraph 4.67, 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 4.33, 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, procedures performed to obtain that understanding are referred to as *risk assessment procedures* because the information obtained by performing those procedures used to support the auditors 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. Standards encourage this by requiring the use of a variety of risk assessment procedures when obtaining an understanding of the entity and its environment. For example, an auditor cannot limit his or her risk assessment procedures to only inquiry.

In addition to providing information about the entity and its environment, including its internal control, the performance of risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures.

Types of Risk Assessment Procedures

The risk assessment and other planning procedures required by SAS Nos. 108 (AU 311) and 109 (AU 314) to obtain information about the entity and its environment, including its internal control, and to assess the risks of material misstatement include the following:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of management and others.

c. Preliminary analytical procedures.

d. Observation and inspection, such as visits to the entity's premises and tracing transactions through the information system (that is, walkthroughs).

e. Discussion among the engagement team.

Each of the procedures listed is explicitly required during risk assessment and, except for observation and inspection is also explicitly enumerated in SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit,* as a source of information that should be considered when identifying risks of material misstatement due to fraud. SAS No. 109 requires previously listed procedures be performed when obtaining an understanding of the entity and its environment. There is no requirement that each of those procedures be performed for every component of the required understanding. However, 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.

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 require 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 Other 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, auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management and others in the governmental unit about the risks of fraud and how they are addressed.
- Consider the results of preliminary 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? The answer 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, operations, and controls.
- Past misstatements and whether they were corrected on a timely basis.

The following paragraphs address the risk assessment procedures 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. In many cases, it 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. As noted earlier, auditors are required to use 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. The auditor should inquire of responsible officials about the following matters:

a. The aspects of the entity and its environment as enumerated in SAS No. 109 (AU 314.21).

b. The information about fraud, suspected fraud, fraud-related programs and controls, and risks of fraud as enumerated in SAS No. 99 (AU 316.20–.21).

Examples of responsible officials that auditors may consider interviewing include:

- The chief executive officer (mayor, city manager, etc.).
- The chief financial officer.
- The controller.

In addition to other inquiries discussed in this lesson, 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?

The auditor might decide that inquiries of others within and outside the entity, in addition to management and those responsible for financial reporting, would be useful. Examples of other inquiries that might be made include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how the financial statements are used. SAS No. 99 (AU 316.22) requires the auditor to inquire directly of those charged with governance (or the audit committee or at least its chair) about the risks of fraud and their knowledge of fraud or suspected fraud.]

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function. [SAS No. 99 (AU 316.23) requires inquiry of internal audit personnel about risks of fraud, knowledge of fraud or suspected fraud, and activities concerning fraud detection.]

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. [SAS No. 99 (AU 316.24) requires inquiry of others within the entity, determined through the auditor's judgment, 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. [SAS No. 99 (AU 316.58) 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 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.

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* indicate 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. [As discussed in section 1301, SAS No. 117 (AU 801), Compliance Audits, has similar requirements for findings that could have a material effect on compliance.] The Yellow Book, at Paragraph 4.09, 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 auditor should integrate the requirements of SAS No. 99 (AU 316) into the risk assessment process. As part of gathering the information needed to identify fraud risks, SAS No. 99 requires auditors to inquire of management and others about:

- Their knowledge of any actual fraud or suspicions of fraud affecting the governmental unit.
- Their awareness of any allegations of fraud or suspected fraud affecting the governmental unit.
- Their understanding of the risks of fraud within the governmental unit, including any specific fraud risks the governmental unit has identified or account balances or transaction classes that may be susceptible to fraud.
- How they communicate to employees the importance of ethical behavior and appropriate business practices.
- Programs and controls the governmental unit has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.
- The nature and extent of monitoring multiple locations or component units and whether any of them have a higher level of fraud risk.
- Whether they have reported to those charged with governance about how the governmental unit's internal control serves to prevent, deter, and detect material misstatements due to fraud.

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 the auditor might consider asking the responsible officials of a governmental unit.

If applicable, the auditor should also inquire directly of the audit committee (or at least its chair) about the committee's understanding of the risks of fraud and its knowledge of any actual or suspected instances of fraud. In addition, the auditor should obtain an understanding of the audit committee's role in overseeing the governmental unit's fraud risk assessment and monitoring process. If the governmental unit does not have an audit committee, inquiries should be made of individuals with a level of authority and responsibility equivalent to an audit committee, such as the oversight body, city council, board of trustees, or others who may have engaged the auditor. Inquiries also should be made of internal auditors if the entity has an internal audit function. The required inquiries of internal auditors are discussed later.

Exhibit 1-3

Inquiries about Fraud Risks for Responsible Officials

Required Inquiry	Possible Questions
Their 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?
Their 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?
Their understanding of the risks of fraud within the governmental unit, including any specific fraud risks the governmental unit has identified or account balances or transaction classes that may be susceptible to fraud.	• 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? • 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?

Required Inquiry	Possible Questions
	• 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?
Programs and controls the governmental unit has implemented to address identified fraud risks or otherwise help prevent, deter, and detect fraud and how those programs and controls are monitored.	• 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 nonroutine 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?
The nature and extent of monitoring multiple locations or component units 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? • 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 how the governmental unit's internal control serves to prevent, deter, and detect material misstatements due to fraud.	• Have you reported to the governing body or audit committee (or its equivalent) about how the governmental unit's internal control serves to prevent, deter, and detect material misstatements due to fraud?

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The auditor should also inquire directly of those charged with governance (or the audit committee or at least its chair) about their views of the risks of fraud and whether they have knowledge of any actual or suspected instances of fraud. In addition, where applicable, the auditor should obtain an understanding of their role in overseeing the governmental unit's fraud risk assessment and monitoring process. Inquiries also should be made of internal auditors if the entity has an audit function.

Inquiries also should be made of 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. At a minimum, the auditor should 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.

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.

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 you should 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 should talk to? • I must ask you 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

* * *

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. Additional audit evidence should be obtained to resolve any inconsistencies among responses.

Documentation. SAS No. 109 (AU 314.122) requires documentation of risk assessment procedures performed in obtaining an understanding of the entity and its environment. When documenting inquiry procedures, SAS No. 103, *Audit Documentation* (AU 339.21), provides the following guidance:

> Audit documentation of procedures performed, including tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation, should include the identifying characteristics of the specific items tested.

In conjunction with this requirement, the standard provides an example for documenting inquiries of specific entity personnel indicating that auditors may document the date of the inquiry, name and job description of the individual queried, and the nature of the inquiry. The auditor should document these identifying characteristics when performing risk assessment inquiry procedures.

Practical aids that can be used by the auditor in documenting the understanding of the entity and its environment and the risk assessment procedures performed are discussed later.

SELF-STUDY QUIZ

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

4. In a school district, inquiries of management in the performance of risk procedures would include conversations with which of the following people?

   a. The superintendent of schools.

   b. Students attending the district.

   c. Taxpayers of the district.

   d. Taxpayers of the neighboring school district.

5. Governmental entities with which of the following characteristic would be at the greatest audit risk?

   a. The 15 major companies in the city operate in 3 diverse industries but their taxes provide 25% of the revenue for the governmental unit.

   b. Property values continue to increase even as neighboring cities experience reductions.

   c. Two of the seven board members are up for re-election.

   d. Bond-rating agencies are considering a negative change in the rating for the entity.

6. To inquire about management's understanding of the risk of fraud in a hospital governmental unit, an auditor would ask which of the following questions?

   a. Are you aware of any actual instances of fraud within the governmental unit?

   b. Have your received any communications from employees, former employees, regulators, or others alleging fraud?

   c. What would be the easiest way for someone to misstate the financial statements or steal assets without getting caught?

   d. What instructions do you give to employees about how they are expected to behave?

SELF-STUDY ANSWERS

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

4. In a school district, inquiries of management in the performance of risk procedures would include conversations with which of the following people? **(Page 139)**

   a. The superintendent of schools. [This answer is correct. The superintendent of schools is the chief executive officer in a school district.]

   b. Students attending the district. [This answer is incorrect. While the auditor may want to consider interviewing others within the entity, students are not management.]

   c. Taxpayers of the district. [This answer is incorrect. The auditor should consider changes in the economy that may affect major taxpayers but would not likely interview general taxpayers. Taxpayers are not management.]

   d. Taxpayers of the neighboring school district. [This answer is incorrect. The taxpayers of a neighboring school district are not management and would have little influence in the risk assessment of the audited school district.]

5. Governmental entities with which of the following characteristic would be at the greatest audit risk? **(Page 139)**

   a. The 15 major companies in the city operate in 3 diverse industries but their taxes provide 25% of the revenue for the governmental unit. [This answer is incorrect. If the government relies on a single source for the majority of revenue, the audit risk increases. This answer describes a diverse tax base.]

   b. Property values continue to increase even as neighboring cities experience reductions. [This answer is incorrect. Audit risk will increase with decrease in tax base leading to financial stress.]

   c. Two of the seven board members are up for re-election. [This answer is incorrect. The election process is a normal process in governmental units. If there was wrongdoing by a board member that caused a resignation and special election, the audit risk would increase.]

   d. Bond-rating agencies are considering a negative change in the rating for the entity. [This answer is correct. A reduction in the bond rating indicates financial distress which can lead to increased audit risk.]

6. To inquire about management's understanding of the risk of fraud in a hospital governmental unit, an auditor would ask which of the following questions? **(Page 141)**

   a. Are you aware of any actual instances of fraud within the governmental unit? [This answer is incorrect. It tests if management has any actual knowledge of fraud.]

   b. Have your received any communications from employees, former employees, regulators, or others alleging fraud? [This answer is incorrect. It tests management's awareness of any allegations of fraud.]

   c. What would be the easiest way for someone to misstate the financial statements or steal assets without getting caught? [This answer is correct. This question tests managements UNDERSTANDING how fraud could take place.]

   d. What instructions do you give to employees about how they are expected to behave? [This answer is incorrect. It tests how management communicates to employees the importance of ethical behavior.]

Preliminary Analytical Procedures

SAS No. 56 (AU 329.04) states that analytical procedures should be applied to some extent in all audits of financial statements to assist the auditor in planning the nature, timing, and extent of other auditing procedures. To accomplish this, SAS No. 56 (AU 329.06) indicates that analytical procedures used in planning the audit should focus on—

a. Enhancing the auditor's understanding of the client's operations and the transactions and events that have occurred since the last audit date.

b. Identifying areas that may represent specific risks relevant to the audit.

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 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.

SLG, Paragraph 4.51, states 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.

SAS No. 56 does not require the use of any particular analytical procedures. It recognizes that the sophistication, extent, and timing of analytical procedures may vary widely, depending on the size and complexity of the client. SAS No. 56 (AU 329.07) states:

> For some entities, the procedures may consist of 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.

Other than the analytical procedures performed to comply with SAS No. 99, 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 most governmental units, the auditor normally has a sufficient understanding of the client and its operations to judgmentally consider the expected relationships. A precise quantification of these relationships is not required and is often not a cost-effective approach. No matter which financial relationships are selected for comparison purposes, the analytical review should 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 should 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 require additional audit attention. Auditors should 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 should 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.

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.

Analytical Procedures Related to Revenue. In addition to the requirement for preliminary analytical procedures in SAS No. 56 (AU 329), SAS No. 99 (AU 316) specifically requires auditors to 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 will not be sufficient to achieve that objective, and other types of analytical procedures should be used. The following examples are some of unusual or unexpected relationships relating to revenue that may indicate a material misstatement due to fraud:

- Actual revenues at significant variance from originally budgeted revenues.
- Actual revenues at significant variance from prior-period actual revenues, without similar changes in the revenue base or rates.
- A significant increase in actual revenues over those of the prior period that is just enough to keep the government from reporting annual or accumulated fund balance, fund equity, or net assets deficits, or from violating debt covenants.
- Large "miscellaneous" or "one-shot" revenues.
- Deferred revenues at significant variance from prior-period deferred revenues.
- Revenue from sales of assets without a similar reduction in the asset accounts.
- Investment income that is contrary to market conditions.
- Expenditure-driven grant revenue without offsetting grant expenditures.

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 should 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 should be considered when identifying fraud risks.

SELF-STUDY QUIZ

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

7. Which of the following is an example of an analytical procedure used to provide an understanding of the operations of the governmental unit?

   a. Comparing general and special revenue fund expenditures by functions and revenue by source for the past several years.

   b. Create a list of long-term obligations.

   c. Compile a list of major taxpayers.

   d. Reconcile the most recent bank statement.

8. An example of an unusual or unexpected relationship to revenue that may indicate a material misstatement due to fraud is which of the following?

   a. Actual revenue is significantly greater than originally budgeted.

   b. A significant amount of deferred revenue.

   c. Revenue from the sales of assets with a similar reduction in the asset accounts.

   d. Expenditure-driven grant revenue with offsetting grant expenditures.

SELF-STUDY ANSWERS

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

7. Which of the following is an example of an analytical procedure used to provide an understanding of the operations of the governmental unit? **(Page 149**)

   a. Comparing general and special revenue fund expenditures by functions and revenue by source for the past several years. [This answer is correct. Analytical procedures are comparisons or ratio analysis. Comparison of general and special revenue accounts may identify a revenue source that requires increased attention in the current audit.]

   b. Create a list of long-term obligations. [This answer is incorrect. According to SAS No. 56, creating a list is not an analytical procedure.]

   c. Compile a list of major taxpayers. [This answer is incorrect. According to SAS No. 56, compilation of a list is not an analytical procedure however, a comparison of the list to last years list or calculation of percentage of tax revenue from the major taxpayers may be used to provide an understanding of the operations.]

   d. Reconcile the most recent bank statement. [This answer is incorrect. Reconciliation of the bank statement is a routine cash control, performed by the staff of the government entity under audit. It would not be considered an analytical procedure used to gain an understanding of the operations of the government unit.]

8. An example of an unusual or unexpected relationship to revenue that may indicate a material misstatement due to fraud is which of the following? **(Page 150)**

   a. Actual revenue is significantly greater than originally budgeted. [This answer is correct. This would indicate a significant variance from expectations. A significant surplus could indicate economic change or budget misstatement. In governmental units, the budget is the control for expenditures. Intentional misstatement of the budget could indicate fraud risk.]

   b. A significant amount of deferred revenue. [This answer is incorrect. According to SAS No. 99, the amount of deferred revenue is a function of the amount of revenue collected compared to the amount of taxes billed.]

   c. Revenue from the sales of assets with a similar reduction in the asset accounts. [This answer is incorrect. If the amount of revenue from sales was different than the reduction in assets there may be an indication of fraud.]

   d. Expenditure-driven grant revenue with offsetting grant expenditures. [This answer is incorrect. Expenditure-driven grant revenue without offsetting grant expenditures may be an indication of fraud.]

Observation and Inspection

Observation and inspection procedures are required when obtaining an understanding of the entity and its environment, including its internal control, to assess risk. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the entity and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, in order to gain an understanding of the client's financing arrangements and underlying covenants, the auditor might decide to review the client's bond agreements and other related documents. That procedure, coupled with a review of the client's financial statements, might be the key procedure that helps the auditor identify risks related to potential noncompliance with 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. Ordinarily, best practices indicate that observation and inspection procedures are 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 required 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. SAS No. 109 (AU 314) requires documentation of risk assessment procedures performed in obtaining an understanding of the entity and its environment. SAS No. 103 (AU 339) provides examples for documenting the identifying chracteristics of observation and inspection procedures. Based on that guidance it is recommended the auditor document the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number.
- 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. (To facilitate inquiring about or requesting copies of the report or document at a later time, refer to the report or document by the same name that the client uses to refer to it.)

Discussion among the Engagement Team

SAS No. 109 (AU 314.14), requires the members of the audit team to discuss the susceptibility of the entity's financial statements to material misstatements. SAS No. 99 (AU 316.14) 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.

The focus of the audit team discussion should 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 more experienced members of the audit team can share their insights based on their cumulative knowledge of the entity and its environment.

Matters to be Discussed. This discussion is aimed at the susceptibility of the financial statements to material misstatement, that is, the areas of vulnerability. Thus, the discussion should not be a narrow one focused on risks already identified, but one that opens 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, should be communicated to the team members. Among other matters, SAS No. 109 indicates that the discussion should include the following:

a. Critical issues and areas of significant audit risk.

b. Areas susceptible to management override of controls.

c. Unusual accounting practices used by the client.

d. Application of GAAP to the entity's facts and circumstances in light of its accounting policies.

e. Important control systems.

f. Materiality at the opinion unit (i.e., financial statement level) (planning materiality) and at the account level (tolerable misstatement).

g. How materiality will be used to determine the extent of testing.

h. 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.

Best practices indicate the discussion also should 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.
- Changes in the client's organization (for example, changes in personnel or accounting systems).
- The nature and complexity of transactions.
- Known accounting and auditing issues.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the client's personnel and assignment of responsibilities. For some smaller entities, the engagement team might consider issues regarding the background and competence of individuals in key processing and financial decision-making roles, especially if concerns had been noted in previous audits.

SAS No. 99 indicates that the discussion should include the following fraud–related matters:

- How and where the entity's financial statements (for example, which accounts or transaction classes) might be susceptible to material misstatement due to fraud.

- How management could perpetrate and conceal fraudulent financial reporting.

- How the entity's assets could be stolen.

- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.

The fraud aspect of the discussion should give appropriate consideration to financial statement misstatement from both fraudulent financial reporting 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? The discussion should also include the appropriate audit response to the areas identified as susceptible to material misstatement due to error or fraud (for example, by identifying the accounts 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. Participants should maintain an attitude of professional skepticism throughout the discussion. Both SAS No. 99 and SAS No. 109 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, SAS No. 109 notes that the auditor should 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) should encourage interaction and an appropriate exchange of ideas. Although SAS Nos. 99 and 109 both require the engagement team to have a specific discussion, communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

The discussion should not be influenced by past favorable experience with the integrity of management. In fact, SAS No. 99 states that the engagement team should abandon neutrality and any preconceptions about management's and employees' honesty, but instead presume the possibility of dishonesty at various levels of management. Thus, 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. Engagement team members should not rely on less than persuasive audit evidence because of a belief that management or employees are honest.

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?
  - 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 and controls?
  - Accounting policies?
- 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 or their application?
  - 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?
- Do you have any concerns about the competency of accounting personnel?
- 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?
- 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 company is authorized or in a position to override controls? Which controls would *you* override if you were in their position?

* * *

Impact 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 should discuss the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team should 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 should be reviewed to make sure there are not any issues that were overlooked.

Who Should Attend the Discussion? Both SAS No. 99 and SAS No. 109 require auditors to exercise judgment in determining who should attend the discussion among the engagement team, but they indicate that the discussion should include the auditor with final responsibility for the audit (generally the audit partner) and ordinarily should comprise key members of the engagement team. Also, 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. Best practices are for the members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion.

When Should the Discussion Occur? Before holding the discussion with the engagement team the in-charge auditor and/or engagement partner should 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 should 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.

The timing of the engagement team discussion and other logistics depend on the circumstances and are not addressed in SAS No. 109, other than to note that for audits involving multiple locations, there may be discussions involving engagement team members in those locations. SAS No. 99 indicates only that the engagement team discussion may occur before or while obtaining an understanding of the client's operating environment and gathering the information needed to identify fraud risks.

Documentation. SAS No. 109 (AU 314) requires that the following items be documented regarding the discussion among the audit team:

- How and when the discussion occurred.
- Subject matter discussed.
- Participating audit team members.
- Significant decisions reached concerning planned responses at the opinion unit and relevant assertion levels.

These requirements are similar to the documentation requirements of SAS No. 99 (AU 316) regarding the fraud–related discussion among the audit team.

SELF-STUDY QUIZ

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

9. What is the purpose of most observation and inspection procedures?

   a. To evaluate the entire internal control system of a governmental unit.

   b. To determine if the governmental unit is in compliance with bond covenants.

   c. To corroborate the results of inquires made of management.

10. SAS No. 109 requires discussion among the engagement team about which of the following topics?

    a. Areas not susceptible to management override of control.

    b. GAAP accounting practices used by the governmental entity's enterprise units.

    c. The need to trust the client throughout the engagement.

    d. How materiality will be used to determine the extent of testing.

11. Which of the following best describes the discussion among the engagement team members?

    a. The discussion should be in memo form and written by the engagement partner.

    b. The team should discuss motivations that may exist for management to intentionally misstate the financial statements.

    c. The discussion should only follow the discussion items outlined in SAS No. 99 and SAS No. 109.

    d. The team should give management the benefit of the doubt, especially if past experience with the governmental unit has been favorable.

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. What is the purpose of most observation and inspection procedures? **(Page 153)**

   a. To evaluate the entire internal control system of a governmental unit. [This answer is incorrect. Observation and inspection procedures are part of the evaluation of internal control. The auditor must also understand the design, control objectives and key controls of the internal control system.]

   b. To determine if the governmental unit is in compliance with bond covenants. [This answer is incorrect. In order to determine if the governmental unit is in compliance with bond covenants, the auditor must also perform financial statement analysis.]

   c. To corroborate the results of inquires made of management. [This answer is correct. Inquiries are made to gain insight into the systems in place as they are represented by management of a governmental unit. Through observation and inspection the auditor can corroborate if systems and procedures are functioning as represented and/or perceived by management.]

10. SAS No. 109 requires discussion among the engagement team about which of the following topics? **(Page 154)**

    a. Areas not susceptible to management override of control. [This answer is incorrect. SAS No. 109 specifically indicates that the audit team should have a discussion regarding areas that ARE susceptible to management override if they have been identified or possible areas of override to be aware of in the audit process.]

    b. GAAP accounting practices used by the governmental entity's enterprise units. [This answer is incorrect. The audit team would need to discuss any unusual practices or circumstances per SAS No. 109. The typical GAAP practices used by the enterprise units would not by itself require discussion.]

    c. The need to trust the client throughout the engagement. [This answer is incorrect. According to SAS No. 109, the audit team needs to exercise professional skepticism throughout the engagement and be alert for other conditions that might indicate misstatement, fraud or errors.]

    d. How materiality will be used to determine the extent of testing. [This answer is correct. The level of materiality should be discussed at the financial statement and account levels.]

11. Which of the following best describes the discussion among the engagement team members? **(Page 155)**

    a. The discussion should be in memo form and written by the engagement partner. [This answer is incorrect. Per SAS Nos. 99 and 109, the discussion should be an open exchange by members of various levels of the audit team, about any issues that may cause potential risk.]

    b. The team should discuss motivations that may exist for management to intentionally misstate the financial statements. [This answer is correct. Management may be motivated by economics, political pressures, lack of ethics and performance appraisal pressure. These are some circumstances that can cause intentional misstatement of the financial statement by overstating revenue, understating of expenditures or even overstating expenditures if revenue is expenditure driven.]

    c. The discussion should only follow the discussion items outlined in SAS No. 99 and SAS No. 109. [This answer is incorrect. The engagement team includes all levels and specialists. Both SAS No. 99 and SAS No. 109 indicate that all members of the engagement team should discuss any circumstance that they feel could cause potential misstatement or fraud.]

d. The team should give management the benefit of the doubt, especially if past experience with the governmental unit has been favorable. [This answer is incorrect. According to SAS Nos. 99 and 109, the audit team should exercise professional skepticism even if they have had past favorable experience with the integrity of management. The management team should abandon neutrality and any preconceptions about management's employees' honesty.]

THE ENTITY AND ITS ENVIRONMENT

The second standard of field work requires an understanding of "the entity and its environment, including its internal control" (AU 150.02). The auditor's focus in obtaining the required level of understanding should be 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. However, 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 should be focused on those matters that could cause material misstatement of an opinion unit, including potential fraud risk factors, undisclosed related-party transactions, illegal acts, 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 the engagement must understand the client's business and industry 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 should 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

The auditor's understanding of the entity and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors.

b. Nature of the entity, 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. Internal control.

As part of understanding the entity and its environment, the auditor obtains an understanding of the entity's selection and application of accounting policies. The selection and application of accounting policies is an integral part of the control environment component of internal control but merits separate and focused attention because of its significance to the auditor's assessment of the risks of material misstatement. Similarly, 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. SAS No. 109 (AU 314.122) indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the entity and its environment to assess the risks of material misstatement.

- Sources of the information from which the understanding was obtained.

- Risk assessment procedures that were performed.

SAS No. 99 (AU 316)requires auditors to document their consideration of fraud risk factors.

Industry, Regulatory, and Other External Factors

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, economic, 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 balance sheet 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 direct and 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 laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each major federal program. The report has to include an opinion on compliance.

SLG, paragraph 4.56, 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:

- Economic, legislative, regulatory, accounting, and auditing developments that affect the governmental industry in general and the client in particular.

- The composition of the reporting entity.

- The government's relationships and transactions with component units.

- The form of government (e.g., a governing board with an elected mayor or a governing board with an appointed manager) for both the primary government and its component units.

- Organizational structure, including the identities and experience of top management.

- 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 nature of joint ventures, if any, and the underlying business rationale for the joint ventures.
- Factors affecting the continued functioning of the government (e.g., taxpayer initiatives that limit budget growth or additional services).
- Debt and investment management policies and the rationale for such policies.
- Budgeting philosophies, including how the budget is balanced in times of economic stress or decline.
- The existence and functions of an audit committee or other group or individual charged with oversight of financial reporting.
- Primary sources of revenue (e.g., property taxes, shared revenues, grants, contracts, and service charges), where and how they are received, and how transactions are authorized, initiated, recorded, and reported.
- Involvement in complex, unusual, or risky activities, and the rationale for entering into such activities.
- Services provided by the government and the resources used for each function or program.
- Services provided (including in-kind services) by separate departments and independent entities (e.g., school districts or redevelopment agencies) and how they are related 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 they are reviewed for relevance and adequacy.
- Opinion modifications in the prior period that could lead to opinion modifications in the current period.
- The status of internal control weaknesses previously communicated to those charged with governance and, if applicable, the reasons why any were not corrected.
- Findings of regulatory or oversight agencies.
- The current status of prior-period findings, including findings and questioned costs that could require reporting of contingent liabilities.
- The nature of any 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. SAS 117 (AU 801) *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 Circular A-133 Compliance Supplement or audit guides issued by grantor agencies.

c. Reading documentation of compliance requirements from previous audits or other engagements and, if applicable, discuss 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 4.83, provides the following examples of the types of compliance requirements that have a direct and material effect on the determination of amounts in a governmental unit's financial statements:

- *GAAP Requirements.* Many governments are required by legal or contractual provisions to prepare their financial statements in conformity with GAAP.

- *Tax Reporting.* Tax reports must be filed in accordance with federal and state requirements (e.g., payroll tax forms, tax-exempt debt requirements, etc.).

- *Legal Authority for Transactions.* Transactions should be properly authorized at execution.

- *Establishment of Funds.* Various legal or contractual provisions may require establishment of funds. Funds may be required by the government's own constitutional or legislative provisions, by that of an oversight government, or by the terms of grants, contributions, and appropriations received from other entities, including other governments.

- *Budgets.* Budgets often specify that particular funds finance particular costs and establish the nature and amount of interfund activity.

- *Tax and Debt Limitations.* Governmental units may be subject to laws and regulations that place limits on taxing authority, place ceiling limitations and other issuance criteria on debt, or place limits on 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.* Governmental units might be prohibited from purchasing certain products or services without obtaining competitive bids or following other purchasing laws and regulations.

- *Time and Other Eligibility Requirements and Purpose Restrictions on Nonexchange Transactions.* Nonexchange transactions must be recognized in accordance with time and other eligibility requirements and purpose restrictions. Noncompliance with these requirements may result in the government having to refund amounts received.

- *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. For example, federal financial assistance programs often stipulate 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 have a direct and material effect on the financial statements for all governmental entities. Also, there may be other types of compliance requirements that do have a direct and 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 SAS No. 117 (AU 801) *Compliance Audits*, *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.

Current Economic Conditions. The current financial and economic instability may affect the entity's operations, risks, and financial reporting. This in turn may affect the auditor's responsibilities in providing auditing services.

AICPA Audit Risk Alert on Economic Instability. The AICPA Audit Risk Alert, *Current Economic Instability—Accounting and Auditing Considerations—2009* helps auditors identify and respond to accounting and audit issues related to the current economic environment.

In general, the current economic instability may create additional audit risks, including risks related to conditions that indicate an entity may not be able to continue as a going concern for a reasonable period of time. In view of the economic recession and the upheaval in financial markets, auditors should carefully consider the implications on their clients and the appropriate audit responses that may be necessary. The AICPA Alert emphasizes how important it is for the auditor to understand the meaning of audit risk given today's economic conditions. Furthermore, due to the rapidly changing economic and regulatory environment, the Alert also underscores the importance of thoroughly understanding the entity and its environment when assessing the risks of material misstatement. Changes in the economy and regulatory environment often complicate the auditor's responsibility related to obtaining that understanding. For example, changed conditions may require the auditor to reconsider his or her understanding about how the economic environment affects the entity, reassess audit risks, and modify planned audit procedures as the audit progresses.

SELF-STUDY QUIZ

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

12. How might a rapidly changing, highly volatile economic environment complicate the auditor's responsibility to assess the risks of material misstatement of the financial statements?

    a. The rapidly changing economic environment may require the auditor to revise his understanding of the entity, re-evaluate audit risks and modify planned audit procedures as the audit progresses.

    b. The current financial crises will have no effect on the auditor's responsibility to provide audit services, because the identified accounting and auditing risks relating to credit and liquidity will remain the same.

13. The insight needed to obtain an effective level of understanding of the governmental unit should come from which of the following?

    a. Individual members of the audit team.

    b. The internal control supervisor.

    c. The partner and manager.

    d. The elected board members.

14. How does the lack of a profit motive for governmental units influence the audit approach?

    a. The audit is easier because the general public is less interested in governmental units than for-profit companies.

    b. The auditors will have fewer accounts to test because there will not be revenue and expense accounts.

    c. The auditors will assure that the governmental units have spent all grant money in the year it is received.

    d. The audit plan is affected by the lack of inherent control of costs as they relate to revenues.

15. Complete the following sentence. In planning the audit of a governmental unit, the regulations that influence the auditor's ability to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations:

    a. should be determined in the final step of the audit.

    b. will be found only in local statutes.

    c. should be included in the permanent file section of the workpapers.

    d. are not influenced by the budgetary process.

16. How do bond covenants affect the audit plan for a governmental unit? Bond covenants:

    a. need not be reviewed in the audit plan process.

    b. may require specific reporting requirements.

    c. only affect the audit if additional debt has been issued since the last audit.

    d. dictate the use of the debt proceeds therefore compliance of bond issues should not be of concern in the audit plan of a governmental unit.

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. How might a rapidly changing, highly volatile economic environment complicate the auditor's responsibility to assess the risks of material misstatement of the financial statements? **(Page 166)**

    a. The rapidly changing economic environment may require the auditor to revise his understanding of the entity, re-evaluate audit risks and modify planned audit procedures as the audit progresses. [This answer is correct. The rapidly changing economic environment may include regulatory changes which will require the auditor to design responsive audit procedures.]

    b. The current financial crises will have no effect on the auditor's responsibility to provide audit services, because the identified accounting and auditing risks relating to credit and liquidity will remain the same. [This answer is incorrect. According to the Standards, the volatile economic environment will result in new risks or more significant risks in the areas relating to the economy, credit and liquidity.]

13. The insight needed to obtain an effective level of understanding of the governmental unit should come from which of the following? **(Page 162)**

    a. Individual members of the audit team. [This answer is incorrect. According to the Standards, each member brings their own experiences and specialized knowledge. As a whole they should provide an effective level of understanding but not as individuals.]

    b. The internal control supervisor. [This answer is incorrect. The internal control supervisor's perspective is from the analysis of loss prevention and compliance and may lack the understanding of external pressures.]

    c. The partner and manager. [This answer is correct. The partner and manager should bring the experience to the team to offer an in depth understanding of the governmental unit and its environment.]

    d. The elected board members. [This answer is incorrect. The elected board members understand the governmental unit from the perspective of their responsibility to their constituents.]

14. How does the lack of a profit motive for governmental units influence the audit approach? **(Page 163)**

    a. The audit is easier because the general public is less interested in governmental units than for-profit companies. [This answer is incorrect. The public sector is interested in the finances of governmental units because they may request services from the government, want to be awarded a governmental contract, want an accounting of taxpayer dollars or other self motivating factors.]

    b. The auditors will have fewer accounts to test because there will not be revenue and expense accounts. [This answer is incorrect. Fund accounting actually uses many more accounts because each fund will have its own set of revenue and expenditure accounts as well as budgetary accounts used for control.]

    c. The auditors will assure that the governmental units have spent all grant money in the year it is received. [This answer is incorrect. There is not necessarily a requirement to spend grant funds in the year received. However, the revenue recognized may be limited to the amount that is spent for expenditure-driven grants.]

    d. The audit plan is affected by the lack of inherent control of costs as they relate to revenues. [This answer is correct. With a profit motive, revenues are driven by the customers' desire to purchase goods and services at a reasonable price and companies try to keep the costs of goods and services low in order to produce a profit for the shareholders. With a lack of profit motive, the auditor must assess the motive of the governmental unit. For example the governmental unit may want to overstate expenditures to increase the next year's budget of a program.]

15. Complete the following sentence. In planning the audit of a governmental unit, the regulations that influence the auditor's ability to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations: **(Page 165)**

    a. should be determined in the final step of the audit. [This answer is incorrect. The regulations and laws should be determined in the beginning of the audit, the planning stage.]

    b. will be found only in local statutes. [This answer is incorrect. Regulations and laws may be federal, state or local.]

    c. should be included in the permanent file section of the work papers. [This answer is correct. The auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations. Excerpts of regulations should be in the permanent file and reviewed each year in planning the audit.]

    d. are not influenced by the budgetary process. [This answer is incorrect. The budgetary process creates laws and regulations that determine the amount of expenditures of a governmental unit.]

16. How do bond covenants affect the audit plan for a governmental unit? Bond covenants: **(Page 165)**

    a. need not be reviewed in the audit plan process. [This answer is incorrect. Bond covenants may have restrictions on funds that need to be addressed in the audit.]

    b. may require specific reporting requirements. [This answer is correct. The auditor needs to attest to the amounts in the financial statements of governmental units and also the many restrictions on funds and expenditures like those found in bond covenants.]

    c. only affect the audit if additional debt has been issued since the last audit. [This answer is incorrect. The restrictions from bond covenants from prior audits is a good place to start. Any restrictions from additional debt should be added to the audit working papers.]

    d. dictate the use of the debt proceeds therefore compliance of bond issues should not be of concern in the audit plan of a governmental unit. [This answer is incorrect. It is because bond covenants may dictate the use of debt proceeds that the auditor needs to attest to compliance as well as the amounts in the financial statements.]

AICPA Audit Risk Alert for State and Local Governments. The AICPA Audit Risk Alert, *State and Local Governmental Developments—2009*, discusses the impact of the economic crisis on state and local governments. It indicates that tax revenues have declined significantly and will continue to do so. Declining property tax revenues, contractual salary increases, and unfunded pension obligations, have forced one local government to file for Chapter 9 bankruptcy protection. The final resolution of that filing will be of interest to other governments facing similar problems and to their auditors.

Governments' credit ratings could be another casualty of the recession. Moody's credit rating activities will focus on local governments that have greater fiscal stress than comparable other governments. A government's failure to make necessary budget adjustments in a timely fashion could place significant downward pressure on its credit rating. The alert indicates that auditors should consider whether there is a risk that the government's credit rating could be lowered. If there is such risk, the auditor should obtain an understanding of the impact on the government's ability to fund its operations and on its outstanding debt obligations.

AICPA Audit Risk Alert for Single Audits. The AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-33 Developments—2009*, explains that the economy might be an important consideration when planning and performing Single Audits and assessing risk. An entity's overall operations could be affected by the economic crisis, which in turn might lead to personnel reductions, changes in the services provided by the entity and administration of its federal programs, and changes in related internal control over compliance.

Nature of the Entity and Its Opinion Units

The auditor should obtain an understanding of the nature of the entity and its opinion units relevant to the audit. The nature of the entity includes its operations; its structure and governance; the types of its investments; and its 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. 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.

Objectives, Strategies, and Related Business Risks

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, Chapter 4, A-11 provides the following examples of areas of risk of material misstatement for a governmental unit:

- The valuation of investments for which there is no market-established fair value.
- The valuation of receivable allowances.

- The valuation of excessive or obsolete supplies inventory.
- Long-outstanding interfund receivables/payables, which may not represent valid rights and obligations.
- The valuation of the recourse liability for receivables sold with recourse.
- The valuation of 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.
- The amount at which a net pension benefit obligation (asset) or net OPEB obligation (asset) is disclosed.
- The existence of restrictions on net assets.
- The classification of revenues 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.
- The classification of capital assets as land versus land improvements versus infrastructure assets, thus affecting classification and allocation of costs.
- The status of specific conditions related to internally generated intangible assets that could affect the classification of the assets as either capital assets or expenses.

Also, SLG, Chapter 4, A-12 explains that a state or local government's management might intentionally:

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

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 best describes the purpose for obtaining the organizational charts of a governmental unit?

    a. From an analysis of the organizational chart, the auditor will be able to determine who really makes decisions and how decisions are communicated.

    b. The auditor should obtain an understanding of the organizational charts but need not include them in the permanent audit file.

    c. The organizational charts will describe the authorities and responsibilities of the audit committee.

    d. The organizational chart will describe positions and personnel which can be used to perform inquiry.

18. Which of the following best describes the auditor's interest in reviewing the budget process?

    a. The budget process may set a legal limit on the amount of expenditures of the governmental unit and therefore is not of concern of the auditor.

    b. One step in the budget process includes amending the originally budgeted revenues and expenditures of the governmental unit.

    c. The auditor only needs to obtain an understanding of the budgeting process by reading relevant statues.

19. In which of the following scenarios would the accounting procedures increase the risk of material misstatement?

    a. Lomo Alto ISD uses specific guidelines to define costs as capital assets vs. expenditures.

    b. The pension benefit obligation for the civilian employees of Goodfellow AFB is determined actuarially and disclosed.

    c. Cash restricted by grant program expenditures is included in the general fund cash account of Tree Hill Municipal Government because the program is administered through the general fund.

    d. The deferred revenue account of Engle ISD is reviewed monthly based on changing economic conditions.

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.)**

17. Which of the following best describes the purpose of obtaining the organizational charts of a governmental unit? **(Page 170)**

    a. From an analysis of the organizational charts, the auditor will be able to determine who really makes decisions and how decisions are communicated. [This answer is incorrect. According to the Standards, the auditor should use inquiry to determine who really makes the decision and how they are communicated.]

    b. The auditor should obtain an understanding of the organizational charts but need not include them in the permanent audit file. [This answer is incorrect. According to the Standards, the organizational charts should be included in the permanent file.]

    c. The organizational charts will describe the authorities and responsibilities of the audit committee. [This answer is incorrect. The organizational charts may include all positions in one chart and the assignment of personnel to positions in another chart including the audit committee if there is one.]

    d. The organizational charts will describe positions and personnel which can be used to perform inquiry. [This answer is correct. The governmental unit should have an organizational chart that describe positions and reporting levels and another organizational chart that includes the personnel assigned to each position and with this information the auditor to evaluate if the organization functions as designed.]

18. Which of the following best describes the auditor's interest in reviewing the budget process? **(Page 171)**

    a. The budget process may set a legal limit on the amount of expenditures of the governmental unit and therefore is not of concern of the auditor. [This answer is incorrect. It is because the budget usually sets the legal limit on expenditures and the tax rate that the auditor should attest to compliance with the law that established the budget.]

    b. One step in the budget process includes amending the originally budgeted revenues and expenditures of the governmental unit. [This answer is correct. The original budget sets legal limits on expenditures but may be amended. Many times the amendments are less public therefore passed with less public scrutiny.]

    c. The auditor only needs to obtain an understanding of the budgeting process by reading relevant statues. [This answer is incorrect. The auditor must attest to compliance with the regulations that are established by the budget process including the original budget and amendments.]

19. In which of the following scenarios would the accounting procedures increase the risk of material misstatement? **(Page 170)**

    a. Lomo Alto ISD uses specific guidelines to define costs as capital assets vs. expenditures. [This answer is incorrect. When the ISD uses guidelines the auditor can evaluate the guideline and test for effective application.]

    b. The pension benefit obligation for the civilian employees of Goodfellow AFB is determined actuarially and disclosed. [This answer is incorrect. Actuarial determination and disclosure of the PBO would illustrate management's intention to obtain transparent disclosure of long-term obligations.]

    c. Cash restricted by grant program expenditures is included in the general fund cash account of Tree Hill Municipal Government because the program is administered through the general fund. [This answer is correct. When expenditure driven grants are administered through the general fund it may be possible to apply some nonqualifying expenditures to the grant.]

d. The deferred revenue account of Engle ISD is reviewed monthly based on changing economic conditions. [This answer is incorrect. A monthly rather than annual review of the deferred revenue account would allow management to adjust to economic changes and reduce the need to make major adjustment at the end of the year to reflect desired outcomes.]

Measurement and Review of the Entity's Financial Performance

The auditor should obtain an understanding of the measurement and review of the entity's financial performance made by management and external parties. Information used by management for measurement and review might include the following:

a. Key performance indicators (KPI), both financial and nonfinancial.

b. Trends.

c. Key ratios and other operating and financial statistics.

d. Forecasts 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 result in detection of misstatements.

c. The auditor might be able to use key performance indicators or other measures used by management when performing analytical procedures. However, the auditor should 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. Management may have already 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 along with the reports that are used to monitor performance.

For all situations, the auditor should consider 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

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. This understanding 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 an OCBOA).

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 standards to a new type of significant transaction there ordinarily is a higher risk of material misstatement for the account balance affected.

The auditor should use 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. SAS 99 (AU 316.50) notes that one of the ways in which judgments about the risk of material misstatement due to fraud have an overall effect relates to accounting principles:

> The auditor should consider management's selection and application of accounting principles, particularly those related to subjective measurements and complex transactions.

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 past experience with the particular 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 both selecting accounting principles and recommending 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 selection of accounting policies. 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. The auditor should identify factors that increase risk to audit areas and evaluate what could go wrong at the relevant assertion level due to the entity's selection and application of accounting policies.

Fraud Risk Factors

When obtaining information about the entity and its environment, the auditor should consider whether the information indicates that fraud risk factors are present. Fraud risk factors are conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Fraud risk factors may be related to fraudulent financial reporting or misappropriation of assets.

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 should 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 should 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. SAS No. 99 (AU 316) 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 presented in SAS No. 99 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.

SLG, Chapter 4, Appendix A, A-6 lists examples of fraud risk factors that are specific to governmental units. Those are reproduced in Exhibit 1-6.

Exhibit 1-6

Governmental Fraud Risk Factors

Incentives/Pressures

- There are or are expected to be laws or regulations that limit resources.
- The entity is subject to unfunded mandates from other governments.
- The entity is subject to public pressure to provide more services with fewer dollars.

- There have been or are expected to be funding cuts from grantors and other resource providers.
- The entity has major taxpayers with declining financial condition or position.
- The entity has a declining property or other tax base.
- The entity is experiencing a declining demand for services.
- The entity's investment values have been negatively affected by the market.
- The entity uses high-risk or exotic investments to maintain or increase investment income.
- The entity has a significant need to obtain debt financing.
- The entity uses complex or "innovative" financing mechanisms.
- The entity is unable to generate sufficient cash flows to cover expenditures.
- The entity is experiencing rapid growth, unusual budget growth, or unusual budget surpluses, especially compared to other, similar entities.
- There is substantial political pressure on management creating an undue concern about reporting positive financial accomplishments.
- Investment analysts, institutional investors, significant creditors, donors, or other external parties have unduly aggressive or unrealistic expectations about financial position or performance, budget results, or program achievements. (Those expectations might have been created by management in, for example, overly optimistic press releases or annual report messages.)
- The entity's financial position or performance is close to violating debt covenants.
- Net assets are in deficit positions, while fund balances are positive.
- The entity is having difficulty developing a balanced budget for next fiscal year due to either anticipated revenue shortfalls or projected excessive expenditures.
- Management expects adverse consequences on significant pending transactions, such as a grant or contract award or modification, if it reports poor financial or program performance.

Opportunities

- Those charged with governance are inexperienced or unqualified.
- Those charged with governance accept management's recommendations and actions without inquiry or debate.
- The entity is subject to complex or frequently changing accounting requirements.
- The entity has financially significant transactions for which there are no or unclear generally accepted accounting principles (GAAP).
- The entity makes excessive use of separate funds, internal service funds, or interfund and internal activity.
- There is a high incidence of patronage employment in positions with significant authority or responsibilities.
- There have been or are expected to be changes in entity management or governing body composition.

- The entity lacks a formal budgeting or planning process.
- The budget is not prepared by the appropriate level of management or is prepared without the input of employees who have a thorough understanding of the budgetary aspects of the entity's activities.
- Budgets are modified after year end to reflect actual results.
- There is uncontrolled access to cash or cash equivalents, such as parking meter receipts and benefit vouchers.
- The entity does not require personnel to provide appropriate documentation for regular time, overtime, or vacation and sick leave time taken.
- The entity awards financially significant contracts without competitive bids, or without due consideration of vendor qualifications.
- The entity gives departmental or agency directors authority to expend certain monies outside of the budgetary process.
- Assets that do not qualify for capitalization for financial reporting purposes are not being marked with identification tags, listed on asset inventory records, or subject to periodic physical inspections or other physical safeguards.

Attitude/Rationalization

- There is an excessive interest by management in meeting or exceeding budgetary targets, maintaining a predetermined level of fund balance, fund equity, or net assets; meeting debt covenant requirements; or maintaining or improving bond ratings.
- Those charged with governance or management do not support public accountability or programmatic efficiencies.
- Those charged with governance or management display a significant disregard for regulatory, legal, or oversight requirements or for federal, state or other regulatory authorities.
- Management has not engaged reputable professional third parties appropriate to the entity's needs, such as attorneys, investment bankers, actuaries, appraisers, financial advisors, and bond counsel.
- Management displays an attitude of (or there is analytical evidence of) the view that funds must be spent on a "use or lose" basis in order to sustain future funding levels.
- Management fails to effectively follow up on questions about financial position, financial performance, or budget variances.

* * *

Auditor's Considerations 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 should be 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 should always 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 should consider them when identifying the risks of material misstatement due to fraud.

If fraud risks are present, SAS No. 109, (AU 314.12), requires that "the auditor should consider 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 transaction, or disclosure 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.

20. When will material misstatement of financial statements and compliance reporting be at a higher risk?

    a. When the governmental entity is large with sophisticated transactions.

    b. When the executive branch is politically motivated to be transparent.

    c. When the governmental unit is experiencing neither growth nor decline.

    d. When the bond rating of the governmental unit has not changed in 10 years.

21. When will an auditor assess the risk of a material misstatement due to fraud as high?

    a. The financial statements are prepared with few transactions for which there are not clear accounting principle applications.

    b. The auditor obtains evidence that the employees of the school district feel they are underpaid.

    c. The budget analysis indicates that the governmental unit has more revenue than in prior periods matched with greater demand for services.

    d. The personnel of the governmental unit remained stable.

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.)**

20. When will material misstatement of financial statements and compliance reporting be at a higher risk? **(Page 177)**

    a. When the governmental entity is large with sophisticated transactions. [This answer is correct. The auditor must exercise more care to understand the aspects of management's selection and applications of accounting policies and procedures when the entity is large with sophisticated transactions.]

    b. When the executive branch is politically motivated to be transparent. [This answer is incorrect. The risk of material misstatement will decrease if the auditor can determine that the executive branch is motivated to be transparent and that motivation is observed in the accounting system.]

    c. When the governmental unit is experiencing neither growth nor decline. [This answer is incorrect. The risk of material misstatement of revenue or expenditures will increase when a governmental unit has increased revenues or increased demand for services because of the political nature of the governmental entities.]

    d. When the bond rating of the governmental unit has not changed in 10 years. [This answer is incorrect. A potential change in the bond rating may lead to higher risk of material misstatement because of the pressure on management to maintain the current or lower bond rating.]

21. When will an auditor assess the risk of a material misstatement due to fraud as high? **(Page 178)**

    a. The financial statements are prepared with few transactions for which there are not clear accounting principle applications. [This answer is incorrect. The opportunity for misstatement would increase if there were many transactions recorded without clear accounting principle application.]

    b. The auditor obtains evidence that the employees of the school district feel they are underpaid. [This answer is correct. Fraud risk factors increase when conditions exist relating to attitudes and/or rationalizations to justify misstating financial statements or misappropriating assets.]

    c. The budget analysis indicates that the governmental unit has more revenue than in prior periods matched with greater demand for services. [This answer is incorrect. Excess revenue unmatched with greater demand for services would lead to an increased risk due to fraud because it would create an opportunity to misappropriate assets.]

    d. The personnel of the governmental unit remained stable. [This answer is incorrect. The risk of misstatement due to fraud increases with increased rates of personnel turnover.]

UNDERSTANDING INTERNAL CONTROL

SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides guidance to auditors related to consideration of internal control as part of an audit. It also provides guidance about how the entity's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit.

Components of Internal Control

SAS No. 109 requires an understanding of five interrelated components of internal control defined and described in COSO's *Internal control—Integrated Framework*. Those components are as follows:

- Control environment.
- Risk assessment.
- Information and communication.
- Monitoring.
- Control activities.

In assessing the risk of material misstatement of an opinion unit in order to develop an overall audit strategy, auditors generally focus on obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components, typically obtaining an understanding of the control environment first. The understanding of control activities is not needed until planning the nature, timing, and extent of further audit procedures at the assertion level. As a practical matter, however, auditors often obtain an understanding of control activities while obtaining an understanding of the other control components. As an entity's operations and systems become more complex, auditors will most likely need to increase their understanding of the internal control components to obtain the understanding necessary to assess the risk of material misstatement of the opinion units and to plan the nature, timing, and extent of further audit procedures.

Nature of the Auditor's Understanding

SAS No. 109 (AU 314.40) 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. The SAS No. 109 requires auditors to perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented. 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.

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 should 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, should also determine if the control, as documented or described, actually exists and the entity is using it. In other words, the auditor should use risk assessment procedures to obtain audit evidence that the control has actually been implemented. Generally, the auditor uses procedures such as observation or inspection, in combination with inquiries, to verify implementation. Inquiry alone is not sufficient to evaluate the design of a control and determine if it has been implemented.

Extent of the Auditor's Understanding

The overriding requirement regarding the understanding of internal control is that it should 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 requires the auditor to develop a fairly thorough and robust knowledge of the components of internal control. That is primarily because the auditor is required to have, and document, the basis for his or her risk assessment rather than just defaulting to high control risk.

Determining the Extent of the Understanding. SAS No. 109 (AU 314.48) clearly indicates that the extent of the understanding of internal control that is sufficient is a matter of professional judgment. 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 and tolerable misstatement.
- Organizational structure.
- Size of the entity.
- Number and nature of operating locations.
- Degree of diversity of systems within the organization, including the use of service organizations.
- Nature of the governmental industry.
- Applicable legal and regulatory requirements.
- The nature of any compliance auditing requirements or special reporting requirements.
- Level of administrative and financial sophistication of the client.

Although the extent of the auditor's understanding is a matter of professional judgment, SAS No. 109 provides certain specific requirements related to the understanding of internal control components. In addition, according to SAS No. 109, the auditor should understand and evaluate the following matters, which may relate to any of the five components:

- The design and implementation of controls, including relevant control activities, related to significant risks (AU 314.115).
- 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 314.117).
- The effect of IT on internal control, specifically how IT affects control activities that are relevant to the audit (AU 314.92).

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

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. Thus, after completing the risk assessment procedures to evaluate internal control design and implementation, the auditor should consider whether a sufficient understanding has been obtained of controls that would prevent, or detect and correct, material misstatements related to fraud risks or other significant risks. If not, the auditor should perform additional risk assessment procedures directed at gaining an understanding of controls relating to those risks.

SLG, Paragraph 4.69, indicates that when considering the nature of the risks, a number of matters should 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 nonroutine 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 should consider the degree of subjectivity in the measurement of financial information and the complexity of the transactions. Significant risk areas in governmental audits might include: the valuation of alternative investments; landfill and pollution remediation liability estimates; OPEB and pension valuation disclosures; 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 should use care not to isolate the understanding to only the control activities component. The auditor should be alert to the fact that significant or fraud risks may not be subject to routine controls given the nature of the risk. Also, the auditor's understanding should extend 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 should evaluate whether the programs and controls that relate to fraud risks and other significant risks are suitably designed and implemented and assess 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 should be sure to consider the control activities that are relevant to account balances with a significant inherent risk of misappropriation of assets. The risk of misstatement due to fraud for misappropriation of assets always depends on whether there are controls to prevent or detect concealment or theft in the accounting records.

In addition to understanding and evaluating controls related to significant risks, auditors are required to understand and evaluate controls related to risks for which substantive procedures alone are not sufficient. For those risks, the auditor will have to perform tests of the operating effectiveness of controls to obtain sufficient audit evidence. Therefore, the auditor needs an understanding of the design of relevant controls and confirmation that they have been implemented before he or she can design and perform appropriate control tests.

Effect of Information Technology (IT) on Internal Control

SAS No. 109 does not address IT as a separate component of internal control—it discusses how IT fits into internal control. While the SAS does not require that auditors take a different approach in considering internal control when an entity uses IT, it indicates that auditors should consider how IT affects an entity's internal controls because IT affects the way transactions are initiated, authorized, recorded, processed, and reported. The effect on internal control is related more to the nature and complexity of the system than to the client's size. Use of the Internet or any other information technology does not necessarily mean that an entity's internal control is heavily dependent on IT.

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors should consider whether specialized IT skills are needed to determine the effect of IT on the audit, understand the IT controls, or to design and perform tests of IT controls or substantive procedures. That determination should be made relatively early in the planning process to assure that the necessary resources are available on a timely basis. The decision to use an IT specialist is a matter of auditor judgment. SAS No. 108 (AU 311.23) states that auditors should consider the following factors in determining whether the audit team should include individuals that possess specialized IT skills:

- The complexity of the entity's systems and IT controls and the manner in which they are used in conducting the entity's business.

- The significance of changes made to existing systems or the implementation of new systems.
- The extent to which data is shared among systems.
- The extent of the entity's participation in electronic commerce.
- The entity's use of emerging technologies.
- The significance of audit evidence that is available only in electronic form.

An IT specialist may be either a member of the auditor's firm or an outside professional.

If the auditor uses an IT specialist on the engagement team, 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 effects 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 auditor's responsibility when using a computer specialist is the same as for other members of the engagement team, as provided by SAS No. 108, *Planning and Supervision* (AU 311). To effectively 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. If the firm uses an outside professional, the guidance in SAS No. 73 (AU 336) should be considered.

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 of Internal Control

As noted earlier, the understanding of internal control should 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 misstatements.
- Consider factors that affect the risks of material misstatement.
- Design tests of controls, when applicable, and substantive procedures.

In addition, the understanding provides audit evidence that contributes to the auditor's planned responses to assessed risks and the performance of further audit procedures. This evidence is an element of the auditor's cumulative audit evidence that ultimately supports the opinion on the financial statements. The auditor should be alert for risks that may be identified during the process of obtaining an understanding of internal controls.

Normally, the auditor's understanding of internal control design and implementation is not sufficient to serve as testing 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) are also used when testing controls, the extent of the procedures to determine implementation may fall short of what is needed to determine operating effectiveness because tests of operating effectiveness need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, in some cases, the auditor's procedures may serve both purposes. For example, a walkthrough can serve as a test of controls and in some cases, along with other procedures that also serve as tests of controls, can provide a valid basis for assessing control risk at less than high. In addition, for an automated control where consistency of application would normally occur assuming the existence of effective IT general controls, the auditor may be able to determine operating effectiveness based on procedures performed to establish that the control has been implemented and the auditor's assessment and testing of the related general controls.

Documentation

SAS No. 109 requires documentation of the understanding of the entity and its environment, including internal control. For internal control, the auditor is required to document the understanding obtained for 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.

Considering Control Objectives and Key Controls

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. 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. Control objectives relate to entity-level controls, such as control environment and monitoring controls, as well as controls at the account balance, transaction class, and disclosure level.

By considering control objectives 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 in SAS No. 109, 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 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 most efficient and effective for the auditor to focus on *key controls*. Many times, these are the controls that the client believes are the most effective and reliable in operation to fully address a control objective. Often, especially for smaller entities, management review controls are key. When determining which controls are key, the auditor might consider factors such as:

- The nature of the risks being addressed.
- The characteristics of related account balances or transaction classes.
- Whether the control is preventive (i.e., prevents misstatements) or detective (i.e., detects misstatements).
- Whether the control works in combination with or relies on the operation of other controls.
- Whether the control is manual or automated.
- Whether the control addresses more than one control objective.
- The nature and type of potential misstatements that the control would prevent, or detect and correct (i.e., would misstatements most likely arise from error, fraudulent financial reporting, or misappropriation of assets)?

UNDERSTANDING ENTITY-LEVEL CONTROLS

This course refers to the internal control components of the control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-level" 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, best practices indicate that auditors obtain an understanding of the entity-level control components first, beginning with the control environment. The following paragraphs discuss each of the entity-level control components. The IT environment and general computer controls also have a pervasive effect and are considered at the entity level.

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. The control environment includes the following elements:

- 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 should obtain 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 responsibilities assumed by management and those charged with governance related to financial reporting are particularly important. For example, the auditor should 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 insure the integrity of financial reporting (that is, the key control environment controls) and (b) any control environment weaknesses that could have a pervasive effect on the financial statements.

Control Objectives. When obtaining an understanding of internal control, many auditors consider control objectives during the process of identifying controls and evaluating their design and implementation. Controls are properly designed and implemented if (a) they achieve the control objectives and (b) the entity is using them. Exhibit 1-7 provides a list of control objectives for each of the elements discussed earlier.

Risk Assessment Procedures and Factors to Consider. When obtaining an understanding of the control environment, the auditor should concentrate on the implementation of control environment elements. 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 should follow through with observation of the behavior and attitude demonstrated by management in managing the governmental unit.

The audit evidence for elements of the control environment is often not available in documentary form. When it is available, the auditor may inspect documents, for example, a written code of conduct, as evidence of how management communicates its views of business practices and ethical behavior. While formal documentation may be preferable, it is not always necessary in order for a policy to be in place and operating effectively. For example, in a small governmental unit, 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.

Exhibit 1-7

Control Objectives—Control Environment

Control Environment Element	Control Objective
Communication and enforcement of integrity and ethical values	Management, through its attitudes and actions, demonstrates character, integrity and ethical values. Sound integrity, and ethical values, particularly of top management, are developed and set the standard of conduct for the organization and financial reporting.
Commitment to competence	The entity is committed to competence in the requirements of particular jobs and in translating those requirements into knowledge and skills.
Participation of those charged with governance	Those charged with governance are actively involved and have significant influence over the internal control environment and financial reporting.
Management's philosophy and operating style	Management's philosophy and operating style are consistent with a sound control environment and have a pervasive effect on the entity. Management analyzes the risks and benefits of new ventures, assesses turnover among employees, investigates and resolves improper business practices, views accounting as a means to monitor and control the various activities of the organization, and adopts accounting policies that reflect economic realities.
Organizational structure	The organizational structure of the government is appropriately designed to promote a sound control environment. Authority and responsibility, appropriate reporting lines, and free flow of information across the government provide unfettered influence to effectively run the entity and support effective financial reporting.
Assignment of authority and responsibility	The entity assigns authority and responsibility to provide a basis for accountability and control.
Human resource policies and practices	Human resource policies and procedures send messages to employees regarding expected levels of integrity, ethical behavior, and competence.

* * *

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 should concentrate on the collective effect of the strengths and weaknesses in the various control environment elements on the risks of material misstatement. This assessment usually affects decisions and judgments made in establishing the overall audit strategy. For example, weaknesses in the control environment might cause the auditor to perform more substantive procedures as of the balance sheet date rather than at an interim date or to use only substantive procedures in more audit areas. Also, while a strong control environment may not completely eliminate the risk of fraud due to the limitations of internal control, it may help reduce the risks of fraud.

As indicated earlier, the auditor should normally obtain 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.

Documentation of the Control Environment. The auditor should document the understanding of each of the control objectives documented in Exhibit 1-7 and provide an overall conclusion regarding whether the control environment is properly designed and implemented considering the overall size and complexity of the entity.

Risk Assessment

Risk assessment is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives. With respect to the objective of reliable financial reporting, the entity's risk assessment process involves the identification, analysis, and management of the risks of material misstatement of the financial statements. An entity's risk assessment process includes the following elements:

- Financial reporting objectives.
- Management of financial reporting risks.
- Consideration of fraud risk.

The auditor should obtain 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 focus on 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 should concentrate 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.

Note that risk assessment as defined in SAS No. 109 (AU 314) is not the same as an auditor's consideration of audit risk (inherent risk, control risk, and detection risk) discussed in SAS No. 107 (AU 312), *Audit Risk and Materiality in Conducting an Audit*. In accordance with SAS No. 107, an auditor assesses inherent and control risks to evaluate the likelihood that the financial statements could be materially misstated. An entity's risk assessment, on the other hand, is the process of identifying, analyzing, and managing risks that affect the entity's objectives. However, management's risk assessment process, as it relates to financial reporting, is somewhat similar to the auditor's assessment of inherent risk. That is, it involves management identifying potential areas of misstatement in the financial statements, including misstatements due to fraud. Management then implements control activities or takes other steps as necessary to prevent or detect such misstatements.

Fraud Risk Assessment and Monitoring. All entities should 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 should 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 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.

Control Objectives. When obtaining an understanding of internal control, many auditors consider control objectives during the process of identifying controls and evaluating their design and implementation. Exhibit 1-8 provides a list of control objectives for each of the elements.

Exhibit 1-8

Control Objectives—Risk Assessment

Control Environment Element	Control Objectives
Financial reporting objectives	• Entity and financial reporting objectives are established, documented, and communicated. • Accounting principles are properly applied in the preparation of the financial statements.
Management of financial reporting risks	• Management has established practices for the identification of risks affecting the entity. • Management considers the entire organization as well as its extended relationships in its risk assessment process. • Management has implemented mechanisms to anticipate, identify, and react to changes. • Management evaluates and mitigates risk appropriately.
Consideration of fraud risk	• Management has developed an appropriate fraud risk assessment and monitoring process

* * *

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 should tailor risk assessment procedures based on factors such as the size and complexity of the entity. However, 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 noted warrant, the auditor should consider asking 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.

The auditor should document his understanding of the entity's risk assessment process, along with the sources of information and procedures performed to obtain or update the understanding and provide an overall conclusion regarding whether the risk assessment component is properly designed and implemented considering the overall size and complexity of the entity.

Information and Communication

Information refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the entity's transactions. It also includes the accountability over assets, liabilities, and equity. An information system may be computerized, manual, or a combination of the two depending on the size and complexity or 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 should 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.

Control Objectives for Information and Communication. When obtaining an understanding of internal control, many auditors consider control objectives during the process of identifying controls and evaluating their design and implementation. Exhibit 1-9 provides a list of control objectives for information and communication.

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 computer is used in those applications, and the relative complexity and importance of use of the computer. The auditor also should consider 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.

Exhibit 1-9

Control Objectives—Information and Communication

Internal Control Area	Control Objectives
Information	• Information is identified, captured, and used at all levels of the entity, and distributed in a form and timeframe that supports the achievement of financial reporting objectives. • Information needed to facilitate the functioning of internal control is identified, captured, and distributed in a form and timeframe that enables personnel to carry out their internal control responsibilities.

Communication	• Communication exists between management and those charged with governance (if separate from management) so that both have relevant information to fulfill their roles with respect to governance and to financial reporting objectives. • All personnel, particularly those in roles affecting financial reporting, receive a clear message from top management that both internal control over financial reporting and individual control responsibilities must be taken seriously. • Personnel have an effective and safe method to communicate significant information upstream in the entity.

* * *

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.

304.26 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.

Communication. The auditor should 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 should 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 must be open channels of communication and a willingness on the part of management to deal with problems. For control activities to be effective, individuals should be able to report exceptions or fraud to the appropriate levels of management.

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 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 should document his understanding of how the control objectives presented in Exhibit 1-9 have been achieved, along with the sources of information and procedures performed to obtain or update the understanding. The auditor should provide an overall conclusion about whether the information and communication process is properly designed and implemented considering the overall size and complexity of the entity, as well as specific controls that relate to each control objective.

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 internal evaluation and (b) 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.

The auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting. 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.

Additional COSO Guidance on Monitoring. COSO issued guidance entitled *Guidance on Monitoring Internal Control Systems*. The materials were developed to help clarify the monitoring component of internal control because it was believed that many entities do not fully understand the concept of monitoring and often fail to fully consider it when assessing their systems of internal control. Furthermore, the guidance is intended to assist entities in (a) identifying and maximizing the effectiveness of monitoring that already exists in the organization and (b) identifying other opportunities for improving monitoring efficiency and effectiveness. The monitoring guidance does not replace or modify any of the guidance contained in COSO's *Internal Control—Integrated Framework*. Auditors, along with their clients, may find the guidance useful when obtaining an understanding of monitoring activities and assessing monitoring controls.

The COSO monitoring guidance indicates that monitoring should be based on three broad elements:

- *Foundation for monitoring.* This encompasses (a) proper tone at the top; (b) an organizational structure that ensures that people with appropriate capabilities, objectivity, and authority assume monitoring roles; and (c) a baseline of known effective internal control in the entity from which ongoing monitoring or separate evaluations can be implemented.

- *Designing and executing procedures.* Monitoring procedures should be focused on the operation of key controls that address meaningful risks. The operation of such controls should provide persuasive information.

- *Assessing and reporting.* This involves the evaluation of the severity of identified deficiencies and the reporting of deficiencies to appropriate personnel for timely action and follow-up, where needed.

COSO's guidance on monitoring consists of three volumes. Volume I discusses the fundamental principles of effective monitoring and the linkage to the COSO framework on internal control. Volume II discusses the principles in greater detail and provides guidance on implementing effective monitoring. Volume III provides examples of effective monitoring. The COSO guidance is available on Checkpoint or can be ordered through the AICPA at **www.cpa2biz.com**.

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. 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 internal auditors. If there is a designated internal audit function, the auditor should obtain an understanding of that function during audit planning. Both SAS No. 65 (AU 322) and SAS No. 99 (AU 316) provide requirements for inquiries related to the internal audit function.

Documentation of the Client's Monitoring Process. The auditor should document his understanding of the entity's monitoring process, along with the sources of information and procedures performed to obtain or update the understanding as well as an overall conclusion regarding whether the monitoring process is properly designed and implemented considering the overall size and complexity of the entity.

IT Environment and General Computer Controls

General Computer Controls. SAS No. 109 (AU 314.96) states that the auditor should consider whether the entity has established effective controls to adequately respond to the risks that arise from IT. Such controls not only include 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 computer controls relate to all automated applications, including user-developed spreadsheet applications.

The AICPA Risk Assessment Audit Guide (paragraph 4.63) notes that the auditor should evaluate the design of IT general controls and determine whether they have been implemented when assessing the risks of material misstatement. Poorly designed general controls do not by themselves cause misstatements in the financial statements. However, deficient general controls may allow application controls to operate improperly which, in turn, can result in material misstatements in the financial statements. SAS No. 109 (AU 314.95) indicates that general controls should 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.

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

An entity with a simple computer system may use primarily paper-based manual procedures to enter sales orders. 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 computer programs. In addition, the nature of the manual controls may be different. Manual controls in an automated system may be independent of the computer 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 computers 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 computers 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 a computerized system, security controls can help achieve segregation of duties. However, the use of computers 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.

IT Environment. Auditors typically learn about the client's IT environment while obtaining an understanding of the IT environment. They should consider what procedures the computer performs and what data is stored in electronic files. As part of the environment, the auditor should understand 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 and if 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.
- Hardware, networks, and other aspects of the entity's computer system.

UNDERSTANDING ACTIVITY-LEVEL CONTROLS

This course refers to the internal control component of control activities, along with the detailed aspects of the financial reporting system, as "activity-level" controls. Activity-level controls and processes operate at the assertion level rather than at the overall financial statement level. Activity-level controls are directly related to initiating, authorizing, recording, processing, 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 computer 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 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, 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 events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include commitments and contingencies, concentrations, 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.

Essentially, 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, it is believed that generally will involve:

- Identifying the entity's significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.
- Understanding the financial reporting process, including how information about other events and conditions (that is, other items included in the entity's significant transaction classes) is captured for inclusion in the general ledger and financial statements.
- Understanding the extent to which IT is used in the entity's financial reporting system.

<u>Identifying Significant Transaction Classes.</u> The auditor should identify significant classes of transactions and obtain 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 selecting significant transaction classes, the auditor should 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 should 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.

<u>Understanding the Flow of Information for Significant Transaction Classes</u>**.** When obtaining an understanding of the flow of information through the entity's financial reporting system, the auditor should focus 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 and processing.*

(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. *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) What management reports or other information are generated from the system that are used 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 must be tested because substantive procedures alone will not be sufficient to address the assessed risks.

The auditor should obtain an understanding of how the incorrect processing of transactions is resolved by the entity. That is a specific requirement of the auditing standards. 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 should identify the related accounts that are material to the financial statements. For material accounts, the auditor should understand the process for reconciling the detail records to the related general ledger accounts. That is another specific requirement of the auditing standards. While reconciling procedures are technically a control activity, the understanding is typically obtained when developing a knowledge of the flow of transactions.

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 should also 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 and how material accounts are reconciled to the general ledger. 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 should obtain an understanding of how automated and manual procedures are used to accomplish the following:

a. Develop significant accounting estimates (for example, OPEB, impairment of long-lived assets, and accrued loss contingencies).

b. Initiate, authorize, record, and process standard and nonstandard journal entries in the general ledger.

c. Initiate and record recurring and nonrecurring adjustments to the financial statements that are not reflected in formal journal entries.

d. Combine and consolidate general ledger data.

e. Prepare financial statements and disclosures, including procedures used to prepare the government-wide financial statements and related reconciliations.

The auditor should be 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.

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, and 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 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. The

AICPA Audit and Accounting Guide, *Audit Sampling*, notes in paragraph 3.25 that a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of controls.

Walkthroughs of transactions usually involve document inspection 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 and related controls 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 should follow the transaction through all of the processing steps in the system. A walkthrough may not be effective if a different transaction is used to test each control separately rather than walking a single transaction through the entire process or if the auditor does not use the same documents and IT that client personnel use. (However, it may be necessary to select additional transactions to verify certain processing steps that may apply for some transactions but not for others. For example, certain of the processing steps and control activities might be different for a sales order originated through an outside sales force versus one originated through a web portal.)

<u>How Often Should Walkthroughs Occur?</u> A nonauthoritative AICPA Technical Practice Aid, *Use of Walkthroughs* (TIS 8200.12) discusses how often an auditor might perform walkthroughs. The use of walkthroughs is a common practice for obtaining an understanding of the design and implementation of the financial reporting system. The TIS notes, therefore, that auditors might perform walkthroughs every year for significant accounting cycles. Even though SAS No. 109 (AU 314) allows the auditor to rely on audit evidence obtained in prior periods in certain situations, the auditor is still required to perform audit procedures to determine the continued relevance of that evidence. In many cases, the auditor can establish this relevance through the performance of a walkthrough. Thus, walkthroughs are ordinarily performed in each audit period for significant transaction classes.

However, best practices indicate that when walkthroughs of significant transaction classes were performed in prior periods, the auditor might be able to alter the nature or reduce the extent of risk assessment procedures performed during current period walkthroughs or, in some cases, rotate walkthroughs by cycle when the client asserts that no changes have occurred. For example, if the client indicates in response to sufficient and appropriate inquires by the auditor that no changes have occurred in the processing steps and related control activities for processing utility billings the auditor might consider changing the nature or reducing the extent of inspection, observation, and reperformance procedures during the current period walkthrough of the utility billings processing system. Also, the auditor might rotate the performance of a walkthrough for certain types of utility billings or, in some cases, for the entire utility billings processing system.

However, best practices indicate that since the auditor is required to apply risk assessment procedures in each engagement and determine whether changes have occurred in the financial reporting system, care should be exercised when considering a reduction of walkthrough procedures. After making appropriate and sufficient inquiries of the client regarding changes in the financial reporting system, the auditor ordinarily considers the extent of corroborating evidence needed to support the client's assertion that no changes have occurred. The auditor might consider the results of other procedures performed to corroborate responses to client inquiries when deciding how much additional corroboration is needed. The auditor also might consider other factors such as the following when deciding whether a reduction of walkthrough procedures in the current year may be appropriate:

- Extent and pervasiveness of relevant entity-level controls.
- Overall significance of the transaction class.
- Types of relevant assertions relating to the transaction class.
- Inherent risk factors relating to the transaction class and associated account balances and disclosures.
- Employee turnover related to transaction processing.

Walkthroughs should not be rotated, however, when changes in the processing system have occurred in the current year. Also, if walkthroughs are rotated, it should be done on a cycle by cycle basis. That is, best practices indicate that some walkthroughs should be performed each year.

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 should be done and (b) the procedure that implements the policy. The auditor's understanding of the other components of internal control, including the control environment, risk assessment, information and communication, and monitoring, is used in assessing the risks of material misstatement at both the financial statement and relevant assertion levels. Certain components, such as the control environment, are more important for developing the overall audit strategy. In contrast, control activities are important at the relevant assertion level for detailed planning of the nature, timing, and extent of further audit procedures.

Control activities, which can be either automated or manual, are performed at various levels within the entity. The auditor should obtain an understanding of those control activities relevant to the audit. This means that the auditor should focus on identifying and obtaining an understanding of control activities that address areas in which the auditor considers material misstatements more likely to occur. The auditor should concentrate on whether and how a specific control activity, individually or in combination with others, prevents, or detects and corrects material misstatements in the classes of transactions, accounts balances, or disclosures that are significant to the financial statements. Specifically, the auditor is required to understand the entity's controls related to fraud risks and other significant risks and also the risks for which substantive procedures alone will not be adequate. Also, as required by SAS No. 109 (AU 314.92), the auditor should understand how IT affects control activities that are relevant to planning the audit.

The 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 computer programs 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.

- *Asset Accountability.* Controls that pertain to reconciliations of the detailed records to the general ledger.

Control policies may be communicated either orally or in writing. This will depend to a great extent on the size of the entity and the channels of communication within it. Also critical to control activities are the follow-up actions taken in response to identified discrepancies (for example, investigation by management of unexpected variances noted while comparing actual expenditures to budgeted expenditures). The auditing standards specifically require the auditor to obtain an understanding of how the incorrect processing of transactions is resolved. Auditing standards also specifically require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for material accounts.

An audit of financial statements does not require an understanding of all control activities related to each class of transactions, account balance, and disclosure or to every relevant assertion, and the auditor should first consider the knowledge about control activities obtained from the understanding of the other components of internal control before devoting additional attention to obtaining an understanding of control activities. (SAS No. 109, AU 314.90) Professional standards specifically require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for material accounts.

Obtaining an Understanding of Control Activities. The auditor should first consider 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 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 should determine if control activities have been identified and understood for those areas where the auditor considers material misstatements are more likely to occur. 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 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 material misstatements in that assertion).

Thus, even if the auditor concludes additional attention to control activities is necessary, the auditor can focus on controls related to specific transactions, account balances, or assertions. The practical implication of this selective approach is that it is not necessary to complete an internal control questionnaire or prepare additional documentation to describe the control activities for all material account balances and transaction classes. The auditor may identify key balances, classes, or assertions and conclude that a further understanding of control activities is necessary only for those selected areas.

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 previous discussion regarding risk assessment procedures and applying walk through procedures to confirm the understanding.

Documenting Control Activities. The auditor should describe the sources of information used and the procedures performed, as well as conclude whether the controls over the significant transaction classes in the audit area are properly designed and implemented.

SELF-STUDY QUIZ

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

22. A strong internal control environment:

    a. will eliminate the risks of fraud.

    b. includes policies and procedures that must be followed in recording transactions thus assuring that all transactions are recorded and the proper amount is recorded.

    c. is affected by the philosophy of executive branch of the governmental unit more than the policies and procedures communicated to its employees.

    d. can be tested by the auditor through inquires, observations and inspection to test that the controls are working.

23. Risk assessment, as it relates to the audit objectives would most likely be affected by which of the following?

    a. A newly appointed superintendent of schools.

    b. An unchanged tax rate.

    c. The annual recalculation of the amount of deferred tax revenue.

    d. A new computer lab in the high school.

24. In obtaining an understanding of the flow of information regarding the purchase of capital assets in a governmental unit, the auditor would be least interested in which of the following?

    a. If the subsidiary ledgers are reconciled to the capital asset account.

    b. How purchases are authorized.

    c. Whether the system is manual or electronic.

    d. Bar codes are used to maintain inventory records of capital assets.

25. Monitoring activities include assessing the quality of the internal control system of a governmental unit over time. Which of the following is true about monitoring activities?

    a. Monitoring activities will result in the detection of fraud in financial reporting and misappropriations of assets.

    b. Monitoring activities are specific tasks outlined in SAS No. 109.

    c. A governmental unit with poor monitoring controls could allow small amounts of cash to be stolen from the General Fund cash account each month.

    d. Monitoring activities relate only to the current financial period.

26. Which of the following least describes a control activity the auditor will perform to gain assurance that the policies and procedures to carry out the objectives of the governmental unit are in place?

    a. The auditor will test that special education grant funds have been used for special education programs.

    b. The auditor will test that assets listed in the capital asset schedule actually exists and are owned by the governmental unit.

    c. The auditor need only perform tests on the way transactions are recorded and affected by the General Fund balance because it is the controlling fund.

    d. The auditor will test to see if the accounts payable clerk of a special revenue fund only pays invoices of authorized vendors of the program.

27. The auditor for the City of Kent should obtain sufficient knowledge of the financial reporting system. Which of the following activities would the auditor perform first in the process to understand the financial reporting system?

    a. Review a list of funds, accounts and various classes of transactions in each fund.

    b. Evaluate the controls on the electronic transactions.

    c. Analysis of information regarding related party transactions.

    d. Understand how information regarding employee ethics compliance training is processed.

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. A strong internal control environment: **(Page 185)**

    a. will eliminate the risks of fraud. [This answer is incorrect. The risk of fraud can be reduced with a strong internal control environment, but cannot be eliminated especially if there is collusion.]

    b. includes policies and procedures that must be followed in recording transactions thus assuring that all transactions are recorded and the proper amount is recorded. [This answer is incorrect. Policies and procedures to record transactions, as part of an internal control system, indicate how transactions should be recorded but cannot guarantee all are recorded correctly if there is an opportunity to override.]

    c. is affected by the philosophy of executive branch of the governmental unit more than the policies and procedures communicated to its employees. [This answer is incorrect. Internal control is affected by both the philosophy of the executive branch and how procedures are communicated to employees. For example, the written and spoken policy may include honesty but if the actions of the executive branch do not exemplify honest behaviors the internal control system is compromised.]

    d. can be tested by the auditor through inquires, observations and inspection to test that the controls are working. [This answer is correct. The auditor must inquire and observe policies and then inspect by testing that account balances and transactions are not materially misstated.]

23. Risk assessment, as it relates to the audit objectives would most likely be affected by which of the following? **(Page 193)**

    a. A newly appointed superintendent of schools. [This answer is correct. The risk assessment would most likely be affected by major changes in the entity that affect financial reporting, management risk and fraud risks. A change in chief operating officer of a school district would increase all of these risks.]

    b. An unchanged tax rate. [This answer is incorrect. An unchanged tax rate could indicate a stable financial base and low affect on risk.]

    c. The annual recalculation of the amount of deferred tax revenue. [This answer is incorrect. The deferred tax revenue account is recalculated annually to determine the amount of revenue to recognize in the financial statements. A significant increase in the account could indicate lower collections than in prior years.]

    d. A new computer lab in the high school. [This answer is incorrect. A new computer system in the accounting department could increase risk but a computer lab in the high school would not likely increase risk.]

24. In obtaining an understanding of the flow of information regarding the purchase of capital assets in a governmental unit, the auditor would be least interested in which of the following? **(Page 200)**

    a. If the subsidiary ledgers are reconciled to the capital asset account. [This answer is incorrect. Reconciliation of the subsidiary accounts with the capital asset account allows the auditor to understand who and when transactions are recorded.]

    b. How purchases are authorized. [This answer is incorrect. Authorizations are key in the auditors understanding of the flow of information to asses risk due to misappropriation of funds.]

    c. Whether the system is manual or electronic. [This answer is incorrect. The auditor needs to understand which parts of the flow of information produce source documents and which are electronic. The auditor also should understand who maintains the electronic system.]

d. Bar codes are used to maintain inventory records of capital assets. [This answer is correct. An understanding of the flow of information regarding the purchase of capital assets would included all transactions and authorizations involved in the process. The bar codes are used after the purchase to safeguard the assets.]

25. Monitoring activities include assessing the quality of the internal control system of a governmental unit over time. Which of the following is true about monitoring activities? **(Page 197)**

  a. Monitoring activities will result in the detection of fraud in financial reporting and misappropriations of assets. [This answer is incorrect. They may reveal evidence or symptoms of fraud not necessarily the detection of fraud.]

  b. Monitoring activities are specific tasks outlined in SAS No. 109. [This answer is incorrect. Monitoring activities can be any activity that ensures that controls are operating as intended and continue to be properly designed.]

  c. A governmental unit with poor monitoring controls could allow small amounts of cash to be stolen from the General Fund cash account each month. [This answer is correct. Monitoring activities include bank reconciliations prepared on a timely basis. Without timely bank reconciliations, the stealing of cash could go on for a long time before discovered.]

  d. Monitoring activities relate only to the current financial period. [This answer is incorrect. Monitoring activities include ongoing internal evaluations and reporting of internal control deficiencies.]

26. Which of the following least describes a control activity the auditor will perform to gain assurance that the policies and procedures to carry out the objectives of the governmental unit are in place? **(Page 205)**

  a. The auditor will test that special education grant funds have been used for special education programs. [This answer is incorrect. Performance review, comparison of current financial reports to other information, is one type of control activities.]

  b. The auditor will test that assets listed in the capital asset schedule actually exists and are owned by the governmental unit. [This answer is incorrect. The physical control that pertain to security of assets including periodic counting and comparison to control accounts is control activity.]

  c. The auditor need only perform tests on the way transactions are recorded and affected by the general fund balance because it is the controlling fund. [This answer is correct. In a fund accounting system there are many interfund transactions. Not all transactions will go through the general fund. The auditor needs to perform control activities on all funds even if they are not material individually if there is a potential for material misstatement by a lack of control in a group of accounts. For example, the school activity fund (slush fund) may be a small amount but all activity funds for the district may require the auditor's analysis.]

  d. The auditor will test to see if the accounts payable clerk of a special revenue fund only pays invoices of authorized vendors of the program. [This answer is incorrect. Segregation of duties, the assignment of different people to authorize transactions, record transactions and maintain custody of assets is a control activity.]

27. The auditor for the City of Kent should obtain sufficient knowledge of the financial reporting system. Which of the following activities would the auditor perform first in the process to understand the financial reporting system? **(Page 200)**

    a. Review a list of funds, accounts and various classes of transactions in each fund. [This answer is correct. To understand the financial reporting system the auditor should first identify the entity's significant account balances and transaction classes. Then the auditor needs to understand the flow of information through accounts and other significant information that is not recorded in accounts. Finally the auditor will look at the closing process. As an overview the auditor must understand the role of IT in each of these steps in the financial reporting system.]

    b. Evaluate the controls on the electronic transactions. [This answer is incorrect. An evaluation of the controls on IT would be part of internal control evaluation.]

    c. Analysis of information regarding related party transactions. [This answer is incorrect. An analysis of related party transactions is part of the internal control evaluation.]

    d. Understand how information regarding employee ethics compliance training is processed. [This answer is incorrect. When the auditor gains an understanding of ethics communications and attitudes, he is performing risk assessment.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (ALGTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated. Which professional standard provides guidance to consider audit risk of a governmental unit?

   a. SAS No. 99.

   b. SAS No. 107.

   c. SAS No. 108.

   d. SAS No. 109.

2. In the audit of a governmental unit, SAS No. 99 provides guidance in which of the following aspects of audit planning?

   a. Compliance auditing in accordance with the Yellow Book and the Single Audit Act Amendments.

   b. Analytical procedures the auditor is required to apply during the planning stage of the audit.

   c. Consideration of fraud in the financial statements.

   d. Detection of illegal acts by the client.

3. Risk assessment procedures are always included as part of the audit plan of a governmental unit. When are risk assessment procedures performed?

   a. At the beginning of the audit so the auditor can better estimate cost.

   b. Before the audit as part of planning and during the audit to take into account new information.

   c. After the audit in order to assess if the general fund statements are materially misstated.

   d. After the audit team has had a discussion regarding risk of fraud.

4. Generally, which of the following serves as a foundation for identifying risks?

   a. Prior-period results.

   b. Obtaining an understanding of the entity and environment.

   c. Observation and inspection.

   d. Inquiry of management and others.

5. Because of the public nature of government, outside parties are interested in the financial statements of the governmental unit. Which of the following is true regarding outside interest in the financial statements of a governmental unit?

   a. Citizens are usually less interested in governmental financial statements than for-profit because significant information about the government is in the news.

   b. County employees' union would only be interested in the financial statement of the County.

   c. Public watchdog groups compare and analyze the financial results of various governmental units.

   d. The Single Audit requirements are not relevant to grant awarding agencies.

6. Observation and inspection would most likely be coupled with which of the following procedures when the auditor is obtaining an understanding of internal control of a hospital?

   a. Inquiry of management and accounts payable employees.

   b. Preliminary analytical processes based on prior audits of the hospital.

   c. Discussion among the engagement team regarding the risk of fraud.

   d. Preliminary engagement activities.

7. The assessment of risk of financial statement misstatement level is at the level of each opinion unit. Which of the following is **not** an opinion unit?

   a. Major enterprise funds.

   b. Major governmental funds.

   c. Fiduciary funds.

   d. The aggregate of nonmajor governmental and enterprise funds, internal service funds and fiduciary funds.

8. Inquiries of management and others are risk assessment procedures to be performed by the auditor. Which of the following would be a question asked of management as part of gathering information related to material misstatement due to fraud?

   a. How do you communicate to employees about the importance of ethical behavior?

   b. Do you maintain manuals describing your current accounting policies and procedures?

   c. Are you anticipating a change in the government's bond rating?

   d. Has your tax base increased from last year?

9. Select the answer choice that best describes a general question relating to risks of material misstatements?

   a. Stacy, staff auditor, asks the engagement team if they have detected any behavior or lifestyle changes that may indicate the existence of fraud.

   b. Patrick, staff auditor, questions the engagement team regarding any accounts that might be vulnerable to manipulation.

   c. Babs, staff auditor, interviews each engagement team member regarding which individuals are most likely to embezzle assets.

   d. John, staff auditor, asks the engagement team question regarding concerns they may have about the capability of accounting staff.

10. After performing risk assessment procedures, the audit team is required to have a brainstorming exchange of ideas that should include which of the following?

    a. Discussion about changes from the prior year that could result in risk of a material misstatement of financial statement.

    b. Only a discussion regarding misstatement of financial statements and have a separate meeting to discuss issues related to potential fraud.

    c. Past audit evidence if the engagement team members believe that management and employees to be honest.

    d. Do not select this answer choice.

11. Which of the following statements best explains the difference between the focus of an audit and the focus of day-to-day management?

    a. The auditor is focused on matters resulting in a possible material misstatement of the financial statements.

    b. Management is focused on preventing and detecting fraudulent transactions that may result in a material misstatement of the financial statements.

    c. The auditor is focused on obtaining a general knowledge level about the entity under audit.

    d. Management is focused on the sufficiency of audit evidence.

12. In the audit of a community college, the auditor should be aware that the risk of material misstatement of the financial statements would most likely arise from which of the following?

    a. An aging student body.

    b. One of the board of regents being arrested for tax evasion.

    c. The federal grant program that funds special education programs being eliminated.

    d. Employees are now required to complete ethics training on-line rather than in a classroom as in prior years.

13. The relationship of state and local laws to the single audit require that the audit be designed to provide reasonable assurance that the financial statements are free of material misstatement that:

    a. could be considered an ethics violation.

    b. are not included in local regulations.

    c. affect governmental activities but not business-like activities.

    d. are in violation of federal laws.

14. The public nature of governmental units compared to a nonpublic company requires the governmental audit be more focused on which of the following?

    a. Accounting principles applied.

    b. Compliance with the budget, laws and regulations.

    c. Fraud.

    d. Related party transactions.

15. How are the number and kind of funds established by a city determined?

    a. By using the prior period's list of funds.

    b. By the legislative provisions of the city governmental unit.

    c. By the current fiscal year's budget.

    d. Do not select this answer choice.

16. The auditor should obtain an understanding of the operating characteristics of the governmental unit. This requires the auditor understand and document all of the following **except**:

    a. Budgeting procedures.

    b. Overall fund structure.

    c. Purchasing procedures.

    d. Ethics training.

17. The risk of material misstatement of financial statements of a governmental unit would most likely occur in which of the following situations?

    a. The short-term investments of Kennedy ISD are recoded at the market-established fair value.

    b. The City of Ross has a storeroom of obsolete supplies inventory.

    c. Trent County calculates its deferred tax revenue at the end of each fiscal year.

    d. The Loma ISD transferred completed construction in progress to the Capital Asset Schedule.

18. The expenditures of a City are limited by its budgeted appropriations. Which of the following analysis should be performed by the auditor to obtain an understanding of the process for adopting and amending budgets?

    a. Compare the appropriations of the current year with those of the prior.

    b. Compare the original budgeted appropriations with final budgeted appropriations.

    c. Compare the amount of actual revenue with original appropriations.

    d. Compare the amount of revenue collected with budgeted revenue.

19. Trends, key ratios, and forecasts are all examples of which of the following?

    a. How the entity's financial performance is measured.

    b. Preliminary engagement activities.

    c. Specialized considerations for government units.

    d. Do not select this answer choice.

20. How should selecting accounting principles and recommending the methods by which they are applied be performed?

    a. The selection should not be part of the audit because it is a time-consuming process.

    b. The selection should be performed by the auditor with regard to consistency or routine matters rather than new policy.

    c. The selection should be handled by the staff auditor rather than managers.

    d. the selection should not be performed by the auditor because of the increased risk of material misstatement in the financial statements.

21. Which of the following is the auditor's main concern when considering fraud risk factors?

    a. Identify if there is a risk factor that should be considered in identifying and assessing risks of material misstatement due to fraud.

    b. Develop an overall strategy.

    c. Determine tolerable misstatement.

    d. Determine tolerable misstatement as a percentage of the auditor's judgment about the amount material to the opinion unit's financial statements taken as a whole.

22. A control objective for a governmental unit states the purpose of a control in relation to risks in the financial statements. Which of the following would be a control objective of a school district?

    a. A new fine arts building is on the bond referendum.

    b. The cafeteria is operated by an outsourcing company.

    c. The athletic booster club deposits concession stand cash sales in its own checking account.

    d. All capital asset transactions are recorded in the Capital Asset Schedule.

23. Computers may enhance the efficiency of internal control because of consistency and accuracy of automated systems. However, which of the following is one risk to internal control by the use of IT?

    a. Reduced risk of override.

    b. Segregation of duties.

    c. Unauthorized changes to programs.

    d. Specialized skills are needed to audit.

24. Increased risk of a material misstatement of the financial statement of a governmental unit could be possible in all the following situations **except**?

    a. A new central computer system.

    b. Restructuring of long-term bonds.

    c. Change to straight-line depreciation on all newly purchased capital assets.

    d. A third year of turnover in the superintendent's position.

25. The audit firm assists with the preparation of financial statements and disclosures for the City of Hillside. The audit firm has a sufficient understanding of the financial reporting system from the initiation of transactions to the preparation of financial statements. Which of the following activities is related to the auditor's understanding of the financial close and reporting process?

    a. The auditor has identified quantitative factors related to the nature of transactions and related account balances.

    b. The auditor has identified the entity's procedures for initiating and authorizing transactions.

    c. The auditor has an understanding of the procedures used to initiate and record recurring and nonrecurring adjusting journal entries.

    d. The auditor understands the aspects of reports generated and used by entity management for controlling the entities activities.

26. Which of the following statements regarding an auditor's understanding of how management communicates significant matters such as financial reporting is most accurate?

    a. Auditors include only external elements when gaining an understanding of how management communicates.

    b. The tone at the top is often expressed through communication.

    c. Communication may be oral, written, or electronic. However, communication through direct actions of management is not allowed.

    d. Do not select this answer choice.

27. Where should an auditor's main focus be when considering the information process at the entity level?

    a. Understand the particular methods related to account balances, transaction classes and disclosures.

    b. Assess the overall use and flow of information pertinent to reliable financial reporting.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

28. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is considered which of the following?

    a. Preliminary analytical procedure.

    b. Walkthrough procedure.

    c. Risk assessment procedure.

    d. Observation and inspection.

Lesson 2: Documentation of the Audit Plan

INTRODUCTION

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. Tolerable misstatement 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.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine materiality at the governmental unit, item and financial statement levels.
- Describe an overall audit strategy.
- Identify the factors unique to governmental units when considering misstatements caused by fraud.

Determining Materiality at the Opinion Unit Level

According to SAS No. 107, *Audit Risk and Materiality* (AU 312.27) the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. SLG, paragraph 4.31, clarifies that in the context of a governmental audit, the concept of materiality for the financial statements taken 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*. SAS No. 107 (AU 312.69) states that the auditor should document the levels of materiality, including any changes thereto, used in the audit and the basis on which those levels were determined. 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 quantitatively material to the opinion unit. According to SAS No. 107 (AU 312.36), the auditor should be alert for misstatements that could be qualitatively material, but it ordinarily is not practical to design audit procedures to detect them.

Quantifying Planning Materiality. Materiality is determined based on the auditor's understanding of the needs and expectations of users of financial statements, but this is a conceptual view. In other words, the auditor considers the needs and expectations of hypothetical general users and does not survey the actual users.

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 financial statements. SAS No. 107 (AU 312.28) acknowledges the appropriateness of this approach and suggests the following factors to consider in selecting a benchmark:

- Elements of financial statements (for example, assets, liabilities, equity, income, and expenses) and GAAP financial statement measures (for example, financial position, financial performance, and cash flows).
- Nature of the entity and the industry in which it operates.
- Size of the entity, nature of its ownership, and the way it is financed.
- Focus of users' attention for the particular entity on particular financial statement items (for example, for governmental units, users may focus more on expenditures than revenues).

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 4.26, explains 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 4.33 states the auditor should make 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—2009* 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 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*—2009, 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 4.44, indicates that the auditor should 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.

Selection of a Benchmark. The first step in determining planning materiality is to specify the benchmark to be used. Conceptually, materiality should be established based on the auditor's understanding of the user's needs and expectations. However, the nature and size of the government are also important factors to consider when selecting benchmarks to establish planning materiality. The characteristics most often identified by practicing auditors as characteristics that are desirable for a benchmark are relative, stability, predictability, and representativeness of entity size.

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, the auditor should 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 expenses/total expenditures, total liabilities, or some other amount is more important to users than total revenue or total assets, then the auditor should estimate the planning materiality amount using that financial statement element as the benchmark.

Items Excluded from the 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 should exclude interfund receivables and agency fund assets. In determining *total revenue* for calculation of planning materiality, the auditor should exclude interfund transfers and bond and other debt proceeds. These adjustments are intended to make the benchmark more representative of the actual size of recurring activity.

Paragraph 4.37 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 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 expenses is usually the most appropriate materiality benchmark. The auditor should use professional judgment in determining the appropriate benchmark for the enterprise funds.

Selecting a Percentage. The next step in making a preliminary judgment about planning materiality is to specify a percentage to apply to the benchmark. There is no authoritative guidance, but as a practical matter an auditor has to develop a usable rule of thumb. Using total assets or total revenue as a benchmark means the audit scope will be driven by the size of the governmental unit. Many auditors believe intuitively that this is appropriate because it agrees with their own past experience in making judgments about audit scope. Also, for intuitive reasons, many auditors believe that the materiality percentage should be adjusted in relation to the size of the governmental unit. They believe the percentage should be larger for a very small government to recognize the practical limits on the effectiveness of audit procedures and smaller for a very large government to recognize the increased risks that usually accompany bigness and the fact that a large enough absolute amount is often considered material.

The reduction of the percentages as the benchmark amount increases serves to prevent the planning materiality amount from becoming disproportionately large in relation to the operating statement. The auditor should, however, exercise judgment and use the rule of thumb as a tool rather than a rigid requirement. The auditor's judgment about the client and its circumstances and uses of financial statements may in some cases result in modification of the planning materiality amount calculated by a rule of thumb.

Planning materiality judgments should be reconsidered as the audit progresses. Because the calculation made during initial planning often uses annualized interim financial information, the base amounts in the annual audited financial statements might differ. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments should made. At the conclusion of the audit, the auditor should consider whether the scope of the audit has been adequate in the circumstances. If planning materiality based on interim amounts is too large, then audit scope might not have been sufficient. If planning materiality based on interim amounts was too small, then the audit would be less efficient than would have been possible because the auditor will have done more audit work than was necessary.

Determining Materiality for Particular Items of Lesser Amounts

In addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than planning materiality could be expected to influence economic decisions of users. According to SAS No. 107 (AU 312.31), "any such amounts determined represent lower materiality levels to be considered in relation to the particular items in the financial statements" for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor should determine whether there are particular financial statement items for which a lower planning materiality amount is appropriate based on user perceptions of the particular items.

SAS No. 107 (AU 312.32), provides the following factors to consider in making this planning decision:

a. Whether accounting standards, laws, or regulations affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions and the remuneration of management and those charged with governance).

b. The key disclosures in relation to the industry and the environment in which the entity operates,

The auditor should 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.

Another way of looking at this requirement is that it is an exception to the general notion that planning materiality is a primarily quantitative determination and opens the determination to a limited group of 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 like interfund activity. The second tier would be particular items of lesser amounts.

Determining Tolerable Misstatement

The auditor must perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the opinion unit financial statements. For this purpose, the auditor needs to establish a tolerable misstatement at the individual account balance, class of transaction, or disclosure level. SAS No. 107 (AU 312.34), defines tolerable misstatement as "the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept." SAS No. 107 (AU 312.69), requires documentation of the level of tolerable misstatement, the basis on which it was determined, and any changes to it as the audit progresses.

Guidance on determining tolerable misstatement is provided in SAS No. 107 (AU 312.35), which indicates, "the auditor should determine one or more levels of tolerable misstatement," and such levels are "normally lower than the materiality levels." In other words, tolerable misstatement should be lower than the materiality level for the financial statements. Materiality for the opinion unit was discussed earlier. Also, for particular items in the financial statements for which a lesser amount than financial statement materiality has been determined the tolerable misstatement should be commensurately lower as well. Therefore, the auditor may determine and document more than one level of planning materiality and more than one level of tolerable misstatement for an opinion unit.

SAS No. 39, *Audit Sampling*, (AU 350.18) as amended by SAS No. 111, provides the following additional guidance on tolerable misstatement:

> This maximum monetary misstatement that the auditor is willing to accept for the balance or class is called *tolerable misstatement* for the sample. Tolerable misstatement is a planning concept and is related to the auditor's determination of materiality for planning the financial statement audit in such a way that tolerable misstatement, combined for all of the tests in the entire audit, does not exceed materiality for the financial statements. This means that auditors should normally set tolerable misstatement for a specific audit procedure at less than financial statement materiality so that when the results of the audit procedures are aggregated, the required overall assurance is attained.

Although this guidance appears in relation to audit sampling, it is applicable to all further audit procedures—not just those involving sampling.

A Practical Approach to Determining Tolerable Misstatement. Professional standards do not discuss how tolerable misstatement should be calculated or any rules of thumb that have been used in practice to calculate tolerable misstatement. SAS No. 107 (AU 312.50) explains that in evaluating audit findings, the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity.

This means that conceptually the combination of the (a) uncorrected known misstatement, (b) projected or estimated misstatement from the application of audit sampling and analytical procedures, and (c) tolerable misstatement for all account balances or transaction classes should be equal to or less than the amount the auditor considers material to the opinion unit's financial statements taken as a whole. The implication is that total tolerable misstatement could be calculated by deducting the auditor's estimate of total known and likely misstatement from planning materiality.

At the planning stage, the auditor cannot know the amounts of *known misstatements* that will be detected and that the client will not correct, or the *projected or estimated 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 calculate total tolerable misstatement. 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 used by the authors is to determine tolerable misstatement 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 detected misstatements. Using this approach, a common rule of thumb is to calculate tolerable misstatement 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 detected misstatements decreases.

The 50% adjustment is based on the maximum adjustment normally made in monetary unit (MUS) or probability proportional to size (PPS) sampling applications to allow for the projected, or likely, misstatements expected in sample results. Usually this 50% adjustment is very conservative, that is, larger sample sizes than necessary will be used. Typically, for small and midsize entities the larger adjustment of 75% will normally be satisfactory. When the auditor expects a relatively large amount of known misstatements to remain uncorrected or relatively large likely misstatements, an adjustment closer to 50% should be used.

The rule of thumb of calculating tolerable misstatement as 75% of planning materiality is appropriate when the auditor uses PPS sampling or an approximation of PPS sampling for all audit sampling applications. The approach to audit sampling is an approximation of PPS sampling. With this approach, the same amount of tolerable misstatement can be used in all sampling applications. This is possible because PPS sampling views the financial statements taken as a whole as a pool of dollars. The tolerable misstatement for the financial statements is applicable to all the account balances and transaction classes included within the financial statements. This amount can also be used to compute individually significant items.

When the auditor uses a statistical sampling approach to substantive tests other than either PPS sampling or a nonstatistical approximation of PPS sampling, another approach to computing tolerable misstatement should be used. This approach is explained in articles and books on use of variables sampling in auditing and is not discussed here. However, the auditor should be aware that when using statistical sampling for variables, the planning materiality amount needs to be allocated to sampling applications for specific account balances or transaction classes. This allocation process is necessary only when classical variables sampling is used.

Caution on Use of Planning Materiality for Evaluation. It is critically important to recognize that the planning materiality amount calculated using a worksheet is the *combined* amount of misstatement. During the audit, an auditor may detect some misstatements in an account balance and may need to decide whether to apply additional procedures. In these circumstances, the auditor should not compare the potential misstatement to planning materiality or to tolerable misstatement. The appropriate comparison for this purpose is to the calculated individually significant amount.

Relating Planning Materiality and Tolerable Misstatement to Accounts and Transactions

The scope of audit procedures for specific account balances and transaction classes should be related to the amount the auditor considers material to the financial statements. SAS No. 107 (AU 312.18) explains this point as follows:

> In determining the nature, timing, and extent of auditing procedures to be applied to a specific account balance, class of transactions, or disclosure the auditor should design audit procedures to obtain reasonable assurance of detecting misstatements that the auditor believes, based on the judgment about materiality, could be material, when aggregated with misstatements in other balances, classes, or disclosures to the financial statements taken as a whole.

Using an explicit amount for tolerable misstatement 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 or transaction class.

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.

SELF-STUDY QUIZ

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

28. In planning materiality of a governmental unit, the auditor must take which of the following actions?

    a. Consider the needs and expectations of the taxpayers by sample survey.

    b. Focus on the success of the governmental unit in serving the needs of the taxpayers.

    c. Establish levels of materiality on the unit level and aggregate level.

    d. Try to incorporate as many qualitative aspects as possible into the evaluation.

29. In determining the materiality benchmark for a governmental unit, the auditor should take which of the following actions?

    a. Always use total assets or total revenue because these are the best indicator of the financial resources of a governmental unit.

    b. Use grant expenditures if grant expenditures will be the focus of the users.

    c. Include interfund revenues and receivables.

    d. Use the same benchmarks for governmental and enterprise funds.

30. What actions should an auditor take in determining the level of tolerable misstatement of a governmental unit?

    a. Determine if there is a calculation requirement in any SAS.

    b. Determine if the level for particular accounts in the financial statements will usually be higher than the materiality level for the financial statements as a whole.

    c. Define the minimum acceptable monetary misstatement for the balance of an account or class of transactions they are willing to accept.

    d. Define the percentage used based on the likely amount of uncorrected known misstatements.

SELF-STUDY ANSWERS

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

28. In planning materiality of a governmental unit, the auditor must take which of the following actions? **(Page 221)**

    a. Consider the needs and expectations of the taxpayers by sample survey. [This answer is incorrect. The auditor needs to consider the needs of the users of the financial statements but in planning materiality; the auditor should use his professional judgment to quantify risk of material misstatement.]

    b. Focus on the success of the governmental unit in serving the needs of the taxpayers. [This answer is incorrect. The success of a governmental unit is usually difficult to determine and seldom can be quantified. This is a fundamental difference in the nature of governmental units and the for profit sector which can measure success on net income or earnings per share.]

    c. Establish levels of materiality on the unit level and aggregate level. [This answer is correct. The benchmark for materiality should be established at the unit level, which is most likely the fund level, and in the aggregate because there may be numerous funds, for example, major Special Revenue Funds, each an opinion unit that make up another opinion unit, governmental activities. Different benchmarks of materiality may be needed for the unit level vs. the aggregate level in order to avoid a material misstatement of the financial statements.]

    d. Try to incorporate as many qualitative aspects as possible into the evaluation. [This answer is incorrect. The planning for materiality in a governmental unit should focus on quantitative factors. Historically the auditors have applied a percentage to a benchmark amount from the financial statements. For example, the benchmark may be 5% of appropriations in the general fund. The auditor should be alert for misstatements that could be qualitatively material, but it ordinarily is not practical to design audit procedures to detect them.]

29. In determining the materiality benchmark for a governmental unit, the auditor should take which of the following actions? **(Page 223)**

    a. Always use total assets or total revenue because these are the best indicator of the financial resources of a governmental unit. [This answer is incorrect. The use of total assets or total revenue as a benchmark may not be appropriate because they are not relevant in all circumstances. For example the utility fund is capital intensive but the special revenue fund to administer special education programs has very few capital assets.]

    b. Use grant expenditures if grant expenditures will be the focus of the users. [This answer is correct. In determining the materiality benchmark the auditor should use professional judgment. The characteristics most often identified by practicing auditors as desirable are relevance, stability and predictability.]

    c. Include interfund revenues and receivables. [This answer is incorrect. Governmental units have many interfund transfers. Revenue may be received by the general fund and transferred to special revenue fund or earned by the special revenue fund but not yet transferred and be documented as a receivable and payable. Interfund transfers should be eliminated if they do not represent an economic resource to the government as a whole.]

    d. Use the same benchmarks for governmental and enterprise funds. [This answer is incorrect. The auditor need not use the same benchmarks for each opinion unit. The benchmark should be relevant to the fund resources.]

30. What actions should an auditor take in determining the level of tolerable misstatement of a governmental unit? **(Page 225)**

    a. Determine if there is a calculation requirement in any SAS. [This answer is incorrect. Professional standards do not discuss how tolerable misstatement should be calculated nor have any rules of thumb been used in practice to calculate tolerable misstatement.]

    b. Determine if the level for particular accounts in the financial statements will usually be higher than the materiality level for the financial statements as a whole. [This answer is incorrect. The level for particular accounts will usually be lower than the materiality lever for the financial statements as a whole because a tolerable misstatement for a sample is the maximum misstatement that the auditor is willing to accept. The tolerable misstatement combined for all of the tests in the entire audit should not exceed materiality for the financial statements.]

    c. Define the minimum acceptable monetary misstatement for the balance of an account or class of transactions they are willing to accept. [This answer is incorrect. Tolerable misstatement is the maximum monetary misstatement that the auditor is willing to accept for the balance or class. In governmental accounting this should be applied to individual funds as well as governmental, enterprise, internal service and fiduciary activities.]

    d. Define the percentage used based on the likely amount of uncorrected known misstatements. [This answer is correct. The auditor, in concept, starts with the estimated amount of uncorrected known misstatements then adds the estimated misstatement from application of audit sampling and analytical procedures. This amount is known as the likely misstatement.]

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. The auditor must consider audit risk for each opinion unit's financial statements taken as a whole. When considering audit risk at the opinion unit level, the auditor should consider risks of material misstatement that relate pervasively to an opinion unit's financial statements taken as a whole and potentially affect many relevant assertions. (These risks are also referred to as *overall risks*.)

Professional standards establish a presumptively mandatory requirement for the auditor to assess and document the risks of material misstatement at the financial statement level (SAS No. 107 AU 312.12 and SAS No. 109 AU 314.122). 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.

At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk. 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 each 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.

Responding to Risks at the Opinion Unit Final Statement Level. SAS No. 110 (AU 318) 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.
- 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.

Exhibit 2-1 provides examples of overall risks and potential responses.

Exhibit 2-1

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 rationale for unusual transactions. • Examine 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 rationale 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 always at least one identified fraud risk (a risk of management override of controls), certain overall responses are required in every audit, as follows:

- The auditor should consider whether the personnel assigned to the engagement possess the necessary knowledge and skills.

- The auditor should consider whether the extent of supervision of personnel is appropriate.

- The auditor should consider the client's selection and application of accounting principles, especially in subjective areas.

- The auditor should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks. Exhibit 2-2 provides examples of overall responses to fraud risks.

Exhibit 2-2

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 analytical procedures and substantive 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. SAS No. 109 (AU 314) requires the auditor to document the assessment of risks of material misstatement at the financial statement level and the basis for the assessment. The auditor is also required by SAS No. 110 to document overall responses to such risks. (Note that the assessment of risks at the financial statement level is really an acknowledgment that there are risks at the financial statement level. The auditor needs to document those identified risks and his or her response.)

Establishing an Overall Audit Strategy

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. It includes the identification of overall risks, the 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.

SAS No. 108 (AU 311.14) provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the characteristics of the engagement that define its scope.

b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the important factors that will determine the focus of the audit team's efforts.

The first two steps 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. The last step 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.

The overall audit strategy includes and is significantly influenced by the auditor's judgments about materiality and the risks of material misstatement at the opinion unit financial statement level. Important aspects of overall audit strategy that determine the focus of the audit team's efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.
  - Materiality for auditors of other locations, if any.
  - Preliminary identification of material locations and account balances.
- 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.
- 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.
- 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 a higher risk of material misstatement.
- Determination of the extent of involvement of professionals possessing specialized skills.
- Additional emphasis on the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the balance sheet date rather than at an interim date.
- Identification of recent significant developments affecting the entity, its industry, its financial reporting, or its legal or economic environment.
- Determination of areas where client assistance is expected to be minimal.

In developing the overall audit strategy the auditor should incorporate decisions and judgments about overall responses to the risks of material misstatement at the opinion unit level. A key outcome of developing the strategy is the determination of resources necessary to perform the engagement including:

- *Personnel Resources for Specific Audit Areas.* This includes the assignment of experienced team members or the involvement of experts for high risk or complex areas as well as the amount of resources for specific audit areas, including the timing of the deployment of such resources.
- *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.

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 competence and 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 should perform tests of controls to gather evidence for use in assessing control risk.

Before designing the audit plan, the auditor should consider 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 should consider 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.

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, SAS No. 109 indicates that 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 information technology (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 other 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.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. SAS No. 114 (AU 380) requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. Since professional standards do not require that a separate audit strategy memorandum be prepared to document all matters that affect 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.

<u>Audit Summary Memo.</u> Although professional standards do not require separate documentation of the audit strategy itself, they do require documentation of any significant revisions to the overall audit strategy to respond to changes in circumstances. However, SAS No. 108 (AU 311.18) observes that a brief memorandum prepared at the

conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, can be updated and changed 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.

31. Which of the following is the risk that there is a material misstatement of the financial statements and the audit will not detect the misstatement?

    a. Unpredictable risk.

    b. Audit risk.

    c. Planning risk.

    d. Internal control risk.

32. Responses to the risk of management's override of controls should include which of the following?

    a. Assignment of personnel to the audit who have worked for the governmental unit in the past.

    b. Assignment to the audit of supervisors who have specific knowledge in governmental accounting systems.

    c. Selection of accounting principles by the audit team to maintain consistency among governmental units audited.

    d. A predetermined timetable of areas to be audited to allow the governmental unit sufficient time to prepare for the audit.

33. The focus of the audit team's effort will be most influenced by which of the following situations as they relate to the audit strategy for a governmental unit?

    a. Management's lack of ethics indicates a higher risk for fraud.

    b. The audit team has only 3 of its 7 members returning from the previous year's audit.

    c. The use of IT is extensive in recording transactions and the same controls are in place as in the prior audit.

    d. Only the audit manager has specialized skill in auditing governmental units.

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.)**

31. Which of the following is the risk that there is a material misstatement of the financial statements and the audit will not detect the misstatement? **(Page 232)**

    a. Unpredictable risk. [This answer is incorrect. While risks may indeed be unpredictable, auditors plan audits to mitigate the risk the financial statements are materially misstated.]

    b. Audit risk. [This answer is correct. Audit risks the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.]

    c. Planning risk. [This answer is incorrect. While there may be some risks when planning an audit, the term "planning risk" is not promulgated in any SAS.]

    d. Internal control risk. [This answer is incorrect. The auditor strives to understand the entity under audit, along with its environment. The auditor will also study internal controls and assess the risk that the internal controls are functioning. However, the term "internal control risk" is not promulgated in any SAS.]

32. Responses to the risk of management's override of controls should include which of the following? **(Page 232)**

    a. Assignment of personnel to the audit who have worked for the governmental unit in the past. [This answer is incorrect. It may be necessary to increase the level of supervision or assign more experienced staff but the experienced staff should not necessarily come from former employees of the governmental unit.]

    b. Assignment to the audit of supervisors who have specific knowledge in governmental accounting systems. [This answer is correct. The auditor assumes a risk of management override of controls but not a risk so great to either decline or withdraw from the engagement. Response to this risk should include assignment of staff with higher experience levels to the audit.]

    c. Selection of accounting principles by the audit team to maintain consistency among governmental units audited. [This answer is incorrect. The audit team does not select accounting principles. This is done by the client. However, the audit team should increase scrutiny of the client's selection and application of accounting policies if the application is complicated or there is suspect fraud.]

    d. A predetermined timetable of areas to be audited to allow the governmental unit sufficient time to prepare for the audit. [This answer is incorrect. Using a greater degree of unpredictability in selecting audit procedures from year to year is one response to addressing the possibility of audit risk.]

33. The focus of the audit team's effort will be most influenced by which of the following situations as they relate to the audit strategy for a governmental unit? **(Page 234)**

    a. Management's lack of ethics indicates a higher risk for fraud. [This answer is correct. The audit strategy is the auditor's operational approach to achieving the audit objectives. It includes identification of overall risks, the overall responses to those risks and the general approach to each audit area. The audit strategy deals with these matters at a high level rather than at the detailed audit plan level.]

    b. The audit team has only 3 of its 7 members returning from the previous year's audit. [This answer is incorrect. The number of personal assigned to the audit team and their experience would be addressed in the detailed audit plan not the audit strategy.]

    c. The use of IT is extensive in recording transactions and the same controls are in place as in the prior audit. [This answer is incorrect. The audit strategy establishes what information will be audited. The use of IT will affect the detailed audit plan.]

    d. Only the audit manager has specialized skill in auditing governmental units. [This answer is incorrect. The audit strategy deals with matters at a higher level by defining the scope, objectives and overall timing of the audit. The assignment of personnel is determined in the audit plan.]

FRAUD CONSIDERATIONS

SAS No. 99 (AU 316), *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. The auditor's consideration of fraud is not separate from consideration of risk at the financial statement, account balance or transaction class levels, but is integrated into the overall risk assessment process. This lesson 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 lesson 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 in conformity with GAAP (or an OCBOA). Therefore, the procedures outlined in this section may be performed concurrently with other procedures, and the evaluation of fraud risks should occur continuously throughout the audit.

Types of Misstatements Caused by Fraud

SAS No. 99 (AU 316.05), defines fraud as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit." The SAS outlines 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.

SAS No. 99 addresses two types of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements resulting from fraudulent financial reporting.
- Misstatements resulting from misappropriation of assets.

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.

In general terms, financial statements are fraudulently misstated through use of the following methods:

- Intentional misapplication of GAAP (or an OCBOA) involving measurement and resulting misstatement of amounts.
- Intentional omission or misrepresentation of information about transactions or events (or intentional misapplication of GAAP involving disclosure).

- Recording fictitious transactions.
- Recording sham transactions (transactions without economic substance, usually involving related parties).

These methods may be facilitated by the creation, falsification, alteration, or other manipulation of accounting records or source documents. Misstatements resulting from fraudulent financial reporting are frequently perpetrated by management through override of internal controls over financial reporting.

The auditor should consider 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 expenditures. Also, the auditor should consider 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 company's assets that results in the financial statements not being presented, in all material respects, in conformity with GAAP (or an OCBOA). 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.

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 should identify 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

SAS No. 107 (AU 312.03) states: "The auditor's responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements whether caused by errors or fraud, are detected." SLG, Chapter 4, Appendix A, clarifies that for governmental entities, this responsibility is applied at the opinion unit level.

SAS No. 99 does not increase the auditor's responsibility for the detection of material misstatement due to fraud. However, SAS No. 99 does require 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.

SAS No. 99 requires the auditor to make an assessment of the risk of material misstatement arising from both fraudulent financial reporting and misappropriation of assets. When assessing the risk of material misstatement due to fraud, the auditor should consider the type of risk, that is, whether it relates to cooking the books or stealing;

the significance of the risk, that is, whether it could result in material misstatement of the financial statements; the likelihood of fraud occurring; and the pervasiveness of the risk, that is, whether it relates to the financial statements as a whole or to specific areas of the statements. This analysis should also include consideration of the direction of the risk for the area of the financial statements that would be affected. Is the risk of potential misstatement a risk of overstatement or a risk of understatement?

The auditor should consider who would have the motivation or incentive to intentionally misstate the financial statements and the form the fraud would be likely to take. 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. This requires that key members of the audit engagement team have, and document, a brainstorming discussion early in the audit about the potential for fraud as previously mentioned.

Also discussed earlier, SAS No. 99 (AU 316.20–.27) requires specific fraud-related inquiries of management, employees, internal auditors, and those charged with governance. The auditor should inquire of management about its understanding of the risks of fraud, programs and controls in place to lessen fraud risks, and whether management knows of any actual fraud or is aware of any alleged fraud in the entity. Similar inquiries should be 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.

SAS No. 99 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. However, SAS No. 99 states that an auditor cannot obtain absolute assurance that the financial statements are free of material misstatements caused by fraud. Because of the nature of audit evidence and the characteristics of fraud, even a properly planned and performed audit may not detect a material misstatement resulting from fraud. Fraudulent activity often involves collusion, misrepresentation, or falsified documents. In addition, fraudulent financial reporting frequently involves management override of controls that in some cases might appear to be operating effectively. As a result, auditors may unknowingly rely on audit evidence that appears to be valid but is, in fact, fraudulent. In addition, audit procedures that are effective for detecting errors may not be effective for detecting fraud.

Immaterial Misstatements Caused by Fraud. AU 110.02 states:

> The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

However, many frauds 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 should detect all cases of fraud, whether the financial statements are materially misstated or not. This perception of the auditor's responsibility goes beyond what is required by professional standards. To eliminate this expectation gap, it is important for auditors to inform their clients about the auditor's responsibility under professional standards. The engagement letter should include language that communicates the auditor's responsibility for fraud detection to the client. (The auditor is required to communicate to the appropriate level of management if he or she determines there is evidence that fraud may exist, even if the matter is inconsequential.)

The Importance of Exercising Professional Skepticism

GAAS requires the auditor to exercise due professional care in planning and performing the audit. SAS No. 1 at AU 230.07 states that "due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence." 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 should 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 should not be 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

SAS No. 99 requires auditors to assess identified risks of material misstatements due to fraud. However, although the SAS uses the term assess, this is not intended to require a separate, specific conclusion on the level of risk such as high, moderate, or low. The SAS indicates that such an assessment is not useful in developing appropriate responses. Rather, the assessment referred to in SAS No. 99 involves determining whether identified risks of material misstatement due to fraud are mitigated by antifraud programs and controls, and the effect of those considerations on the auditor's response.

SAS No. 99 states that the auditor should ordinarily presume there is a risk of material misstatement due to fraud relating to revenue recognition. Because governmental entities 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.

SAS No. 99 outlines the following fraud risk assessment process (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 and to reinforce the importance of professional skepticism.

b. Obtain other information needed to identify risks of material misstatement due to fraud. Risk factors and related matters were discussed earlier.

c. Identify risks that may result in material misstatement of the financial statements due to fraud.

d. Assess the identified risks after taking into account an evaluation of the government's antifraud programs and internal controls.

e. Respond to the results of the risk assessment.

Documenting the Fraud Risk Assessment. Although SAS No. 99 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 SAS No. 107. SAS No. 107 defines audit risk at the account balance or transaction class level as consisting of three components: inherent risk, control risk, and detection risk. SAS No. 99 requires the auditor to assess the identified risks of material misstatement due to fraud, but it does not add another component to the audit risk model. This is because fraud risks encompass both inherent and control risk attributes. The auditor should make 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 should consider whether the audit programs are appropriate in light of the assessed risk of material misstatement.

SAS No. 99 (AU 316.83) requires 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:

- The discussion among engagement team members in planning the audit.
- The procedures performed to gather information needed to identify and assess fraud risks.
- Fraud risks identified.
- The response to those risks.
- If applicable, how the auditor overcame the presumption that improper revenue recognition is a fraud risk.
- The results of procedures to address the risk of management override of controls.
- Additional conditions, if any, requiring a response and the response(s) to those conditions.
- The nature of communications about fraud.

Exhibit 2-3

Practical Approach to Fraud Risk Assessment

SAS No. 99 Requirements	Practical Approach to Fraud Risk Assessment
Hold a discussion among engagement team members to consider the susceptibility of the client's financial statements to material misstatement due to fraud and to reinforce the importance of professional skepticism.	**Step 1.** Gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements due to fraud: • Discussion among engagement team members.
Obtain other information needed to identify risks of material misstatement due to fraud.	• Inquiries of management and others. • Considering whether fraud risk factors are present. • Preliminary analytical procedures. • Other procedures.
Identify risks that may result in material misstatement of the financial statements due to fraud.	**Step 2.** Identify risks that could result in material misstatement of the financial statements due to fraud.

SAS No. 99 Requirements	Practical Approach to Fraud Risk Assessment
Assess the identified risks after taking into account an evaluation of the entity's antifraud programs and internal controls.	**Step 3.** Assess the identified risks: • Evaluate programs and controls. • Assess fraud risks.
Respond to the results of the risk assessment.	**Step 4.** Develop appropriate responses to risks of material misstatement of the financial statements due to fraud: • Overall responses. • Specific responses. • Responses to further address the risk of management override of controls.

* * *

Detection of Illegal Acts

SAS No. 54 (AU 317), *Illegal Acts by Clients*, indicates that the auditor's responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement line–item amounts is the same as that for other errors and fraud. For indirect-effect illegal acts, the auditor, in conducting the audit, remains aware of their possibility but does not design the audit specifically to detect them. However, if specific information comes to the auditor's attention that provides evidence about possible material misstatements resulting from indirect-effect illegal acts, the auditor has to apply audit procedures specifically directed to determining whether an illegal act has occurred. If an illegal act has occurred or is likely to have occurred, the auditor has to determine the effect on the financial statements and the implications for other aspects of the audit.

As part of audit planning, the auditor should make inquiries of responsible officials concerning the client's compliance with laws and regulations. Where applicable, the auditor should also inquire about (a) the client's policies related to the prevention of illegal acts and (b) the use of directives (for example, a code of ethics) and periodic representations obtained from management-level employees concerning compliance with laws and regulations. Responses to these inquiries should be documented. If an illegal act is detected during the audit, SAS No. 54 requires that it be communicated to those charged with governance, unless clearly inconsequential. (Auditors should be familiar with any applicable state statutes regarding communication to outside parties and should consider consulting with legal counsel.) Also, a representation from management regarding the absence of violations of laws or regulations is ordinarily included in the management representation letter.

Other Considerations for Fraud, Illegal Acts, Noncompliance, and Abuse in an Audit of a Governmental Unit

GAAS Requirements Related to Compliance with Laws and Regulations. In the audit of a governmental unit, substantial attention is given to compliance with laws and regulations. According to the GAS/A-133 AICPA Audit Guide, paragraph 3.16, the auditor's responsibilities under AU 317 include identifying laws and regulations that may have a direct and material effect on the financial statements and then assessing the risk that noncompliance with those laws and regulations may cause the financial statements to contain a material misstatement. (The phrase laws and regulations implicitly includes provisions of contracts and grant agreements.)

Although management is responsible for ensuring that the governmental unit complies with laws and regulations applicable to its activities, the auditor is responsible for considering laws and regulations and how they affect the audit. The GAS/A-133 AICPA Audit Guide, paragraph 3.18, states that the auditor should:

- Assess whether management has identified compliance requirements that have a direct and material effect on financial statement amounts.

- Obtain an understanding of the possible effects of the compliance requirements on the financial statements, for example by considering:

    - Quantitative and qualitative materiality;
    - The likelihood of noncompliance occurring;
    - Management or employee involvement in compliance assurance; and
    - The opportunity to conceal noncompliance.

- Assess the risk that a material misstatement occurred because of noncompliance.
- Design and perform the audit to provide reasonable assurance of detecting such material noncompliance.

The GAS/A-133 AICPA Audit Guide, paragraph 3.19, 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 entity's chief financial officer, legal counsel, or grant administrators.
- Obtain management's written representation about completeness of their identification of compliance requirements.
- Review applicable parts of directly-related agreements.
- Identify revenue sources, review related agreements, and inquire about overall regulations applicable to accounting for the revenue.
- Obtain publications relating to compliance requirements, such as Department of the Treasury requirements pertaining to arbitrage.
- Obtain and review relevant sections of laws and regulations, including 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.

SAS No. 117 Requirements. SAS No. 117 (AU 801) *Compliance Audits*, provides guidance on applying GAAS when the auditor is engaged (or legally required) to perform an audit of compliance in accordance with GAAS, *Government Auditing Standards*, and a governmental audit requirement that requires an opinion on compliance, such as a Single Audit.

***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, illegal acts, noncompliance, and abuse.

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 direct and material effect on financial statement amounts or other financial data significant to the audit objectives. The Yellow Book also establishes requirements related to noncompliance that might have material *indirect* effects. The Yellow Book, Paragraph 4.11, states that if information comes to the auditor's attention about possible violations of provisions of contracts or grant agreements that could have a material indirect effect, the auditor should perform procedures specifically to determine whether such violations have occurred. If the auditor concludes that a violation has occurred or is likely to have occurred, the auditor has to determine the effect on the financial statements and the implications for other aspects of the audit.

Requirements Related to Abuse. *Government Auditing Standards* also establish requirements related to abuse. The concept of abuse is different from that of fraud, illegal acts, or noncompliance. The Yellow Book indicates that abuse "involves 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. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate." It may or may not involve fraud, illegal acts, or noncompliance with contracts or grant agreements.

The determination of abuse is very subjective. Thus, auditors are not required to provide reasonable assurance of detecting abuse. Instead, Paragraph 4.13 of the Yellow Book states that if auditors become aware of abuse that could be material (either quantitatively or qualitatively) to the financial statements, they should perform additional procedures to determine its potential effect on the financial statements or other financial data significant to the audit objectives. These additional procedures involve (a) evaluating whether the situation or transaction meets the definition of abuse or whether it also involves fraud or illegal acts and (b) evaluating whether the situation or transaction involves 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.

Requirements Related to Ongoing Investigations or Legal Proceedings. The Yellow Book clearly states that it is important for auditors to avoid interfering with ongoing investigations or legal proceedings. Paragraph 4.29 of the 2007 Yellow Book explains that when investigations or legal proceedings have been initiated or are in process, the auditor should evaluate the impact on the audit. It may be necessary for the auditor to work with investigators or legal authorities, to withdraw from the engagement, or to defer further work on the engagement, or a portion thereof, to avoid interfering with the process.

Developing Elements of a Finding. If the auditor finds fraud, illegal acts, noncompliance, abuse, or internal control deficiencies, the auditor should plan and perform additional procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. The Yellow Book, explains that these elements are criteria, condition, cause, and effect or potential effect.

Communication Requirements. The Yellow Book establishes specific requirements for auditors to communicate fraud, illegal acts, noncompliance, and abuse, including requirements for reporting to outside parties in certain situations.

SELF-STUDY QUIZ

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

34. In the governmental entities, grants are a material source of revenue; therefore the auditor should consider which of the following when evaluating the possibility of fraud in the audit of grants?

    a. Grant revenues may be unintentionally understated because of the restrictions placed on recognition of the revenue.

    b. Grant revenues may be overstated because the governmental unit intentionally misclassified expenditures.

    c. The misstatement of grant revenue could only occur unintentionally because the auditor has worked with the client for several years and believes them to be honest.

    d. Management has assigned an experienced employee to assure compliance with grant covenants therefore the revenue and matching expenditures must be correct.

35. Even though SAS No. 99 states that an auditor cannot obtain absolute assurance that the financial statements are free of material misstatements the auditor is required to see that all of the following safeguards are in place **except**:

    a. Key members of the audit team have a brainstorming session regarding who in the governmental unit would have incentive to commit fraud and document the session.

    b. All members of the audit team must be knowledgeable about the IT system because it can pose the greatest risk of fraud.

    c. The audit team should ask employees and management if they are aware of anyone in the governmental unit who is committing fraud.

    d. The auditor must identify and assess risks that may lead to fraudulent actions by management or employees.

36. Each of the following situations is an example of a condition under which a fraud may occur in a governmental unit **except**:

    a. Management or other employees want to misstate financial statements in order to keep their expenditures within budget.

    b. The ability of managers or employees to override controls that can lead to misstatement of financial statements.

    c. Management or employees can justify the misstatement of financial statements to continue a program they believe to be vital to the citizens they serve.

    d. Management or employees failed to record transactions because the source documents were lost.

37. When the management of a governmental unit "cooks the books" (fraudulent reporting) which of the following situations may occur?

    a. The controller recorded fictitious transactions to purchase assets and had the assets delivered to her personal residence.

    b. An accounting clerk recorded sham transactions to help his brother-in-law's program look profitable.

    c. The manager of an enterprise fund did not record sales and deposited the cash in his pocket.

    d. The mayor received a holiday basket worth $1,200 from the company constructing the new city hall.

38. In the audit of a city the auditor must be aware of issues that are different than an audit of a for-profit client. Which of the following audit issues would most likely **only** occur in the audit of a city?

    a. Illegal acts by management can lead to misstatement of the financial statements.

    b. The expenditures exceeded the maximum allowed by statute.

    c. The entity is not in compliance with the bond covenants.

    d. Capital asset account includes items that should be written off in the current year.

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.)**

34. In the governmental entities, grants are a material source of revenue; therefore the auditor should consider which of the following when evaluating the possibility of fraud in the audit of grants? **(Page 244)**

    a. Grant revenues may be unintentionally understated because of the restrictions placed on recognition of the revenue. [This answer is incorrect. An unintentional misstatement is does not constitute fraud.]

    b. Grant revenues may be overstated because the governmental unit intentionally misclassified expenditures. [This answer is correct. Fraud requires an intentional act. The governmental unit may want to classify expenditures of one fund/program to another fund/program in order to list grant qualifying expenditures therefore recognize and receive grant revenue.]

    c. The misstatement of grant revenue could only occur unintentionally because the auditor has worked with the client for several years and believes them to be honest. [This answer is incorrect. The auditor is required to exercise professional skepticism which is an attitude that includes a questioning mind even if the auditor believes in management's honesty and integrity.]

    d. Management has assigned an experienced employee to assure compliance with grant covenants therefore the revenue and matching expenditures must be correct. [This answer is incorrect. An assurance employee does not in of itself guarantee the lack of fraud. The auditor is required to assess if the control could effectively mitigate the risk and whether the control is operating effectively.]

35. Even though SAS No. 99 (AU 316) states that an auditor cannot obtain absolute assurance that the financial statements are free of material misstatements the auditor is required to see that all of the following safeguards are in place **except**: **(Page 243)**

    a. Key members of the audit team have a brainstorming session regarding who in the governmental unit would have incentive to commit fraud and document the session. [This answer is incorrect. The audit team is required to have a brainstorming session and document the meeting. The focus should be on the individual members of the audit team 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 their work affects other aspects of the audit.]

    b. All members of the audit team must be knowledgeable about the IT system because it can pose the greatest risk of fraud. [This answer is correct. The use of IT does not pose a greater risk of fraud than a manual system. If the IT system is complicated, the audit team should include a specialist.]

    c. The audit team should ask employees and management if they are aware of anyone in the governmental unit who is committing fraud. [This answer is incorrect. The auditor should use inquiry in the process of specifically identifying and assessing risks caused by fraud. One aspect of inquire is to simply ask employees and management if they are aware of anyone committing fraud.]

    d. The auditor must identify and assess risks that may lead to fraudulent actions by management or employees. [This answer is incorrect. SAS No. 99 requires the auditor to specifically identify and assess risks due to fraud. Fraudulent activity often involves collusion, misrepresentation or falsified document. Auditors are required to assess fraud at the opinion unit level governmental entities.]

36. Each of the following situations is an example of a condition under which a fraud may occur in a governmental unit **except**: **(Page 241)**

    a. Management or other employees want to misstate financial statements in order to keep their expenditures within budget. [This answer is incorrect. Fraud includes falsified documents. The auditor should be aware of the political nature of governmental units to say within budget as well as a legal obligation to do so.]

    b. The ability of managers or employees to override controls that can lead to misstatement of financial statements. [This answer is incorrect. Managers may have the ability to transfer money among various funds to misrepresent the source of actual expenditures.]

    c. Management or employees can justify the misstatement of financial statements to continue a program they believe to be vital to the citizens they serve. [This answer is incorrect. Fraud is an intentional misrepresentation. The motivation to continue a program, for example, a homeless shelter, may cause misrepresentation of the financial statement if managers or employees feel that is the only way to continue to provide the service. The audit team should use professional skepticism when they identify political pressures.]

    d. Management or employees failed to record transactions because the source documents were lost. [This answer is correct. Fraudulent activity involves collusion, misrepresentation, or falsified documents. This example does not describe fraud but rather lack of some internal controls to safeguard source documents.]

37. When the management of a governmental unit "cooks the books" (fraudulent reporting) which of the following situations may occur? **(Page 241)**

    a. The controller recorded fictitious transactions to purchase assets and had the assets delivered to her personal residence. [This answer is incorrect. This fraud is a misappropriation of assets. Misappropriation can be committed by causing the entity to pay for goods and services not received or paying inflated prices for goods and services received.]

    b. An accounting clerk recorded sham transactions to help his brother-in-law's program look profitable. [This answer is correct. Fraudulent reporting are intentional misstatements, or omissions, of amounts or disclosures from the financial statement s with the intent of deceiving financial statement users.]

    c. The manager of an enterprise fund did not record sales and deposited the cash in his pocket. [This answer is incorrect. This fraud is a misappropriation of assets. This type of fraud may be facilitated by the falsification, alterations, or other manipulation of accounting records or source documents, possibly by circumventing controls.]

    d. The mayor received a holiday basket worth $1,200 from the company constructing the new city hall. [This answer is incorrect. Accepting gifts is not fraud but may be a violation of ethics guidelines of the governmental entity. The auditor should consider such a violation in the assessment of risk.]

38. In the audit of a city the auditor must be aware of issues that are different than an audit of a for-profit client. Which of the following audit issues would most likely **only** occur in the audit of a city? **(Page 246)**

   a. Illegal acts by management can lead to misstatement of the financial statements. [This answer is incorrect. Illegal acts can occur in a city or for-profit entity.]

   b. The expenditures exceeded the maximum allowed by statute. [This answer is correct. Fund accounting used by governmental units is based on budgeted revenues and appropriations. The budget entry sets the appropriation level for each fund and becomes the legal limit the government can spend. When the government spends its appropriation it is called an expenditure (even if it is spent on capital assets).]

   c. The entity is not in compliance with the bond covenants. [This answer is incorrect. Cities and for-profit entities both issue bonds that may have covenants.]

   d. Capital asset account includes items that should be written off in the current year. [This answer is incorrect. The inappropriate capitalization of costs can occur in both a city and for-profit company. The city uses fund accounting, therefore the cost would be called an expenditure and would originate in a one fund then be recorded a second time in the schedule of capital assets.]

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. A general program that includes planning procedures common for most engagements should include information about the entity and its environment, the design and implementation of internal control, and the entity's financial reporting system. The general program should also identify and assess potential risks to the financial statements, including the risk of fraud and provide a summary of common inquiries and discussions with client personnel relating to (1) planning and (2) general audit procedures.

Some firms complete the 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, SAS No. 99 requires auditors 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.

PLANNING THE 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 should have some estimate of audit time to arrive at a fee estimate. Keeping track of the time spent as the audit progresses is important for billing the client, assessing whether adjustments are necessary to stay within the budget for the engagement, or proposing additional fees to the client.

Methods used in practice to budget and control time range from elaborate systems that budget time by each program step to a single total time estimate for the entire audit. Neither extreme is likely to be effective. The auditor could use a system that accounts for time by each major audit program area, for example, total time for cash. Other major engagement processes should also be considered such as planning activities, review and supervision, and drafting financial statements and other 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 required 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 should be emphasized that the final audit time estimate should 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 must present a fee estimate to a client, especially to a prospective client. However, auditors should 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 should try to get the client to prepare as many of the necessary schedules as possible. However, many inefficiencies can result from the process of obtaining schedules from the client. For example, schedules may not be prepared by the time the auditor needs them so that the auditor ends up spending time preparing the schedules and exceeding the budget for the area. Or in other cases, the schedules are prepared on a timely basis, but incorrectly; so the auditor spends additional time revising the schedules to make them useable. The following paragraphs discuss steps the auditor can take to minimize the inefficiencies often experienced when requesting schedules from the client.

List Everything Needed. When preparing a list of schedules to be prepared by the client, the auditor should make sure 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.

Make Sure the Client Understands What Information Is Being Requested. When making requests for information from the client, the auditor should be specific about what is needed. For example, the auditor should avoid making requests such as "provide an analysis of activity in the deferred revenue account." The client should be given an example of the format in which the information should be provided. 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 should go over the PBC list in detail with the client to ensure that the client understands what information is being requested.

Do Not Ask for Unneeded Information. The auditor should not be spending much (if any) time on insignificant accounts. Therefore, the auditor should 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.

Prioritize Requests for Information. One way to improve audit efficiency is for the auditor to work on the riskier, more complex areas first. As a result, if the auditor identifies problems in the complex areas, the client has more time to correct or research the problems. To facilitate this approach, the auditor should request that the client prepare the schedules for the more complicated areas first.

Stagger Due Dates for Requested Information. Ideally, the client should have all requested schedules prepared when fieldwork begins. However, because there may be a tight deadline between year end and the due date of the auditor's report, it may not be feasible for the client to have all information prepared before the beginning of fieldwork. If this is the case, the auditor should be realistic when setting the due dates for requested information and not ask for everything to be prepared at once. Information for the critical areas should be requested first.

Provide Adequate Notice. Although this seems obvious, many auditors are inefficient because they do not provide the client with enough time to prepare for the audit before fieldwork begins. Early preparation of the PBC list is an important step in the planning process and should not be a difficult task because the auditor generally spends time in up front planning before fieldwork begins. The auditor should ask the client how much lead time is needed to adequately prepare for the audit.

Work with the Client. In many cases, the auditor can use the client's existing internal reports to achieve the same objectives as by using a schedule prepared solely for the audit. The auditor 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 useable format, the auditor should attempt to get the client to do this task.

Return Incorrect Schedules to the Client. If the client provides the auditor with schedules that are prepared incorrectly, the auditor should return them to the client for corrections. If the client does not have the time to revise the schedules, the auditor should 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. Such communication should be made 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.

39. In planning the audit of a governmental unit, the auditor is required to document certain aspects of the planning process in documentation called the general program. The general program is required to include all of the following **except**:

    a. The auditor's understanding of the entity, its environment and its internal control.

    b. The auditor's assessment of risks of material misstatement of financial statements at various reporting levels.

    c. The auditor's working time budget including assignment of specialized personnel.

    d. The auditor's assessment of risk due to fraud or support for a lack of risk due to fraud.

40. In the final step of planning the audit of a governmental entity, the auditor will need to request information from the client. This information should be completed prior to fieldwork. Which of these scenarios is the most efficient way to utilize the client in gathering information?

    a. The auditor will ask the city manager to provide a list of all taxpayers who paid late in order to reconcile the Revenue from late charges.

    b. The auditor will provide a template to the client where he can list transactions between the Capital Projects Funds and Capital Assets Schedule.

    c. The auditor should communicate to the client that all information is required on the first day of the fieldwork.

    d. The auditor should request some information one month before the fieldwork begins then ask request additional information 2 weeks prior to field work in order to spread out the work load for the client.

SELF-STUDY ANSWERS

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

39. In planning the audit of a governmental unit, the auditor is required to document certain aspects of the planning process in documentation called the general program. The general program is required to include all of the following **except**: **(Page 254)**

    a. The auditor's understanding of the entity, its environment and its internal control. [This answer is incorrect. SAS requires auditors to document their understanding of the entity, its environment and its internal control, including the sources of information from which the understanding was obtained and the risk assessment procedures that were performed.]

    b. The auditor's assessment of risks of material misstatement of financial statements at various reporting levels. [This answer is incorrect. SAS requires auditors to document their assessment of the risks of material misstatement both at the financial statement level and the relevant assertion level and the basis for the assessment.]

    c. The auditor's working time budget including assignment of specialized personnel. [This answer is correct. The final audit time estimate should 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). Auditors should avoid the temptation to develop the audit time estimated based solely on the fee estimate.]

    d. The auditor's assessment of risk due to fraud or support for a lack of risk due to fraud. [This answer is incorrect. SAS required auditors 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.]

40. In the final step of planning the audit of a governmental entity, the auditor will need to request information from the client. This information should be completed prior to fieldwork. Which of these scenarios is the most efficient way to utilize the client in gathering information? **(Page 255)**

    a. The auditor will ask the city manager to provide a list of all taxpayers who paid late in order to reconcile the Revenue from late charges. [This answer is incorrect. The auditor should not ask for unneeded information. The auditor should not ask the client to prepare schedules for insignificant accounts or those that can be tested analytically.]

    b. The auditor will provide a template to the client where he can list transactions between the Capital Projects Funds and Capital Assets Schedule. [This answer is correct. The client should understand what information is needed. The client should be given an example of the format in which the information should be provided. In this case the client should be provided with the template.]

    c. The auditor should communicate to the client that all information is required on the first day of the fieldwork. [This answer is incorrect. The auditor should provide the client with enough time to prepare for the audit before fieldwork begins. The auditor should ask the client how much lead time is needed to adequately prepare for the audit.]

    d. The auditor should request some information one month before the fieldwork begins then ask request additional information 2 weeks prior to field work in order to spread out the work load for the client. [This answer is incorrect. When preparing a list of schedules to be prepared by the client, the auditor should list everything that is needed. If a complete list is provided to the client before fieldwork begins, the client is more likely to have the schedules completed before the audit starts.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (ALGTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

29. The following is a list of possible opinion units. Which ones require separate materiality determination?

    1. Each major governmental fund.
    2. Each major enterprise fund.
    3. Aggregate discretely presented components units.
    4. Aggregate remaining fund information.

    a. 1.

    b. 1 & 2.

    c. 1, 2, 3 & 4.

    d. 1, 2 & 3.

30. In selecting a benchmark for the capital projects fund, the auditor of Liberty ISD would most likely include which of the following?

    a. Agency fund assets.

    b. Interfund receivables.

    c. Transfers from the general fund to capital projects fund.

    d. Transfers from the capital projects fund to pay expenditures.

31. A tolerable misstatement is the maximum error in a population that the auditor is willing to accept. In determining this level the auditor would consider which of the following?

    a. Professional standard guidelines for the calculation of amount of the tolerable misstatement.

    b. The levels of tolerable misstatement should be lower than materiality levels.

    c. The auditor should use the level of tolerable misstatement established in the planning stage.

    d. Each opinion unit should have the same level of tolerable misstatement to avoid a material misstatement of the government-wide statements.

32. At what point of the engagement should an auditor reconsider any planning materiality judgments?

    a. Start of the audit.

    b. During the audit.

    c. End of the audit.

    d. Do not select this answer choice.

33. If the auditor discovers that the superintendent of Unity ISD is overriding controls, the auditor should take which of the following actions?

    a. Withdraw from the audit regardless of the amount of perceived risk of material misstatement of the financial statements.

    b. Consider whether the personnel assigned to the engagement possess skills to deal with the superintendent.

    c. Ask the superintendent why the controls are overridden in order to obtain an understanding of how school districts operate.

    d. Use consistent audit procedures from year to year in order to determine the amount of misstatement due to the override.

34. Which of the following statements regarding documentation of overall strategy is most accurate?

    a. Auditors should utilize complex strategies when preparing documentation that affects audit strategy.

    b. Auditors should prepare a separate documentation of the audit strategy in accordance with the professional standards.

    c. Auditors should document important revisions to the overall strategy responding to changes in circumstances.

    d. Do not select this answer choice.

35. Fraud is an intentional act by employees or management that results in a material misstatement of the financial statements. Which of the following is **not** an example of fraud?

    a. Intentional omission of the receipt of grant funds.

    b. Recording fictitious expenditure transactions.

    c. Recording amounts from a source document with a mathematical error.

    d. Transfer resources from one fund to another in order to meet debt covenants.

36. In the evaluation of risk due to fraud, the auditor will perform all of the following actions **except**:

    a. Make an assessment at the beginning stages of the audit that will assure taxpayers that there is no fraudulent activity going on in the governmental unit.

    b. Inquire about management's understanding of fraud and its risks.

    c. Observe and inspect that policies in place are functioning to reduce the risk of fraud.

    d. Hold a brainstorming meeting with the audit team regarding who, If anyone, in the governmental unit is most likely to have an motive to commit fraud.

37. When the management of a governmental unit misappropriates assets, which of the following situations may occur?

    a. The city manager approved a fictitious supplier and issued invoices instructing the checks be sent to her personal post office box.

    b. The sales from the last day of the year were recorded as revenue in the following year for the city golf course fund because the fund had already reached its budgeted revenue for the year.

    c. An accounting clerk recorded sham transactions to help the government be in compliance with debt covenants.

    d. The mayor accepted a birthday gift worth $1,000 from the bank president.

38. In the audit of a governmental unit, like a city, the auditor must be aware of issues that are different from an audit of a for-profit client. Which of the following is most likely to **only** occur in the audit of a city?

    a. A manager has embezzled cash through collusion with the accounts receivable clerk.

    b. The entity is not in compliance with debt covenants.

    c. Costs to extend the life of delivery trucks were written off in the current year but should be capitalized.

    d. A Single Audit is required which involves compliance with laws and regulations.

39. When should the final audit time estimate be completed?

    a. Before the planning stage.

    b. After the planning stage.

    c. During the audit.

    d. Upon completion of the audit.

40. When the auditor requests information from the client to be completed prior to fieldwork, which of the following steps will help expedite this process?

    a. Stagger requests for information so the client is not overwhelmed by the auditor's requests.

    b. The auditor should find time to correct any incorrect schedules prepared by the client rather than return the schedules to the client for correction.

    c. Provide a template so the client knows what information is requested and will provide it in the requested format.

    d. Request that the client prepare the schedules for the least complicated areas so the auditor can focus on the most complicated areas.

GLOSSARY

Audit Evidence. The term evidential matter has been replaced by audit evidence. Auditing theorists drew a distinction between the things the auditor obtained, such as supporting source documents and confirmation responses, which were evidential matter, and their significance to the auditor's judgment. Evidential matter became evidence after being evaluated by the auditor. This theoretical distinction has been discarded. SAS No. 106, paragraph 2, states:

> Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information.

Audit Plan. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members to obtain sufficient appropriate evidence. The audit plan is commonly referred to as the audit program.

Audit Strategy. The audit strategy (previously called the audit plan is the auditor's operational approach to achieving the objectives of the audit. It is a high-level determination of the audit approach by audit area. It includes the identification of audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the general approach to each audit area as being substantive procedures or a combined approach of substantive procedures and tests of controls. The risk assessment standards require that the auditor establish the overall strategy for the audit.

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 has a significant influence.
- Characteristics of governmental units influence selection of a benchmark.
- Certain items need to be excluded from the calculation of the benchmark.

Control Activities. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, which can be either automated or manual, are performed at various levels within the entity. The auditor should obtain an understanding of those control activities relevant to the audit.

Control Objectives. A control objective states the purpose of a control (or controls) in relation to risks and "what could go wrong" in the financial statements. By considering control objectives 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.

COSO Framework. Established based on the recommendations of the National Commission on Fraudulent Financial Reporting (known as the Treadway Commission after its first chairman, former SEC Commissioner James C. Treadway) in the 1980s, a task force of the Committee of Sponsoring Organizations of the Treadway Commission undertook a project to, among other things, define internal control, describe the components of effective internal control, and provide criteria against which internal control can be evaluated. Issued in 1992, the COSO Report has increasingly become a widely accepted framework for sound internal control.

Fraud Risk. 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.

General Program. 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.

Management Inquiry. Inquiry of management and others is used extensively throughout the audit planning process. Generally, the auditor will make inquiries of the chief executive officer of the executive branch (for example, the mayor, city manager, head county judge, superintendent of schools, etc.).

Management Override. Fraudulent activity often involves collusion, misrepresentation, or falsified documents. In addition, fraudulent financial reporting frequently involves management override of controls that in some cases might appear to be operating effectively.

Materiality Level. The preliminary judgment about materiality at the financial statement level is generally referred to as planning materiality.

Misappropriation of Assets. Misstatements resulting from misappropriation of assets (often referred to as defalcation, embezzlement, theft, or employee fraud) involve theft of the company's assets that results in the financial statements not being presented, in all material respects, in conformity with GAAP (or an OCBOA).

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.

OPEB. Other postemployment benefits.

Opinion Unit. 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.

Public Watchdog. Groups that compare and analyze governmental units' financial results.

Reasonable Assurance. The scope paragraph of the auditor's report includes a statement that generally accepted auditing standards (GAAS) require audits to be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. That statement introduces the concept of materiality to the audit report and the auditor's responsibility for detecting errors or fraud. SAS No. 104 amends paragraph 10 of SAS No. 1 to expand the definition of reasonable assurance. SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of audit assurance.

Risk Assessment Procedures. According to SAS No. 106, paragraph 20, risk assessment procedures are a defined category of audit procedures performed near the beginning of an audit to obtain an understanding of the entity and its environment, including its internal control, for the purpose of assessing the risks of material misstatement at the financial statement and relevant assertion levels. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures. Risk assessment procedures consist of inquiry, observation, inspection, and analytical procedures.

Risk of Material Misstatement. The risk of material misstatement is the likelihood of a misstatement of the financial statements of a material amount. The auditor should assess this risk at both the financial statement level and at the relevant assertion level. At the financial statement level, it is an overall assessment. At the relevant assertion level, it is the combination of the auditor's assessment of inherent risk and control risk. The auditor can make a combined assessment of inherent and control risk or assess the component risks separately and then combine them.

SAS 99. SAS No. 99 requires auditors to consider whether fraud risk factors are present.

SAS 107. Guidance on determining tolerable misstatement is provided in SAS No. 107 (AU 312.35), which indicates, "the auditor should determine one or more levels of tolerable misstatement," and such levels are "normally lower than the materiality levels." In other words, tolerable misstatement should be lower than the materiality level for the financial statements.

SLG. AICPA Audit and Accounting Guide, *State and Local Governments*.

Use of Information Technology. The use of computers 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 computers 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 a computerized system, security controls can help achieve segregation of duties. However, the use of computers also poses certain risks to a client's internal control.

COMPANION TO PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS

COURSE 3

AUDIT PROGRAMS (ALGTG103)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course explains the organization, format, and use of audit programs for a governmental engagement. Topics covered include audit strategy, the design of audit programs and the organization of audit programs. The course also discusses core audit programs and certain accounting guidance.
PUBLICATION/REVISION DATE:	March 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Audits of Local Governments*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of governmental accounting
CPE CREDIT:	7 QAS Hours, 7 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's Government Auditing 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 **March 31, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Audit Strategy and Organization

Completion of this lesson will enable you to:
- Implement an audit strategy, tailored as needed, to achieve the objectives of the audit based on risk assessments made.
- Utilize general and specific audit programs effective for local government engagements.

Lesson 2—Auditing the Financial Statement

Completion of this lesson will enable you to:
- Develop the relevant assertions for various accounts, including cash, investments, revenues, expenditures, operating assets, debt and equity.
- Select substantive audit procedures for various accounts, including cash, investments, revenues, expenditures, operating assets, debt and equity.
- Prepare an audit program for various accounts.
- Apply the accounting and disclosure considerations relevant to local government financial statements.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
ALGTG103 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

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

Lesson 1: Audit Strategy and Organization

INTRODUCTION

This course explains the organization, format, and use of audit programs for a governmental engagement. It begins with a consideration of the audit strategy, factors underlying the design of the audit programs, and the reasons for the organization and format chosen for the programs. It also discusses each of the core audit programs, including certain accounting guidance.

Learning Objectives:

Completion of this lesson will enable you to:

- Implement an audit strategy, tailored as needed, to achieve the objectives of the audit based on risk assessments made.
- Utilize general and specific audit programs effective for local government engagements.

Audit Strategy

The audit strategy is the auditor's high-level operational approach to achieving the objectives of the audit. It encompasses the identification of overall risks, the 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.

SAS No. 108, paragraph 17, notes that "once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources." The audit plan is commonly referred to as the audit program. SAS No. 108, paragraphs 19-20, states:

> The auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Organization of Audit Programs

The general procedures programs consist of the following:

- *General Planning Procedures*, which include engagement acceptance procedures, the procedures for obtaining an understanding of the entity and its environment, internal control, assessing the risk of material misstatement, determining planning materiality, etc.
  - *Other General Planning Procedures*, which include planning procedures related to matters such as using the work of other auditors or specialists.
- *General Auditing and Completion Procedures*, which include procedures required by SASs 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*, which include procedures that may be warranted such as voluntary disclosures in financial statements, related party transactions, potential fraud or illegal acts, omitted procedures and subsequent discovery of facts, etc.
- *Audits of Federal Award Programs—General Procedures*, which includes general procedures for Single Audits in accordance with OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* and SAS No. 117 (AU 801), *Compliance Audits*.

The general procedures programs are discussed throughout this course.

SELF-STUDY QUIZ

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

1. Decide how the following elements of an audit relate to each other and rank them in order from least detailed to most detailed.

   i. Audit strategy.

   ii. Audit plan.

   iii. Audit objectives.

   a. Audit strategy, plan, and objectives.

   b. Audit strategy, objectives and plan.

   c. Audit plan, objectives and strategy.

   d. Audit objectives, plan and strategy.

2. Listed below are some definitions of audit elements. Select the choice which correctly defines an audit plan.

   a. The auditor's high-level approach to achieving the objectives of the audit.

   b. The representations that management makes, implicitly or explicitly, regarding the recognition, measurement, presentation and disclosure of information in financial statements.

   c. More detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members.

   d. Consists of (i) tests of details of classes of transactions, account balances and disclosures and (ii) substantive analytical procedures.

3. From the answer choices below, select the choice that best describes how an audit strategy is implemented.

   a. The audit strategy is an operational approach to achieving the objectives of the audit.

   b. The auditor first documents the audit procedures to be used, then establishes the nature and timing of the audit procedures and lastly determines the extent of testing necessary.

   c. The auditor first accepts the engagement, then obtains an understanding of the entity, its environment and internal control and lastly, the auditor assesses the risk of material misstatement.

   d. The auditor first identifies the overall risks, then the overall responses to those risks and lastly the auditor decides upon the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls.

4. Listed below are descriptive titles for general and specific audit programs. Classify the titles between general and specific.

   i. General planning procedures

   ii. Basic procedures

   iii. Extended procedures

iv. General auditing and completion procedures

v. Audits of federal award programs

vi. Other audit procedures

a. General procedures: i, ii and iii. Specific procedures: iv, v and vi.

b. General procedures: i, iv and v. Specific procedures: ii, iii and vi.

c. General procedures: iv, v and vi. Specific procedures: i, ii and iii.

d. General procedures: i, ii and v. Specific procedures: iii, iv and vi.

5. From the audit program titles listed in Question 4 above, which one includes steps to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level?

   a. General planning procedures.

   b. Basic procedures.

   c. Extended procedures.

   d. Other audit procedures.

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. Decide how the following elements of an audit relate to each other and rank them in order from least detailed to most detailed. **(Page 269)**

   i. Audit strategy.

   ii. Audit plan.

   iii. Audit objectives.

   a. Audit strategy, plan, and objectives. [This answer is incorrect. The order in which the choices are listed in the question is not the correct order of least detailed to most detailed per SAS No. 108.]

   b. Audit strategy, objectives and plan. [This answer is correct. The audit strategy is the auditor's high-level approach to achieving the objectives of the audit. Once the audit strategy is established, the auditor develops the detailed audit plan, commonly referred to as the audit program.]

   c. Audit plan, objectives and strategy. [This answer is incorrect. The answer choice does not correctly relate the elements of an audit from least detailed to most detailed per SAS No. 108.]

   d. Audit objectives, plan and strategy. [This answer is incorrect. According to SAS No. 108, the audit strategy is not the most detailed element of an audit.]

2. Listed below are some definitions of audit elements. Select the choice which correctly defines an audit plan. **(Page 269)**

   a. The auditor's high-level approach to achieving the objectives of the audit. [This answer is incorrect. This is the definition of an audit strategy.]

   b. The representations that management makes, implicitly or explicitly, regarding the recognition, measurement, presentation and disclosure of information in financial statements. [This answer is incorrect. The representations made by management are audit assertions. The auditor will make also make assertions related to classes of transactions, account balances and presentation and disclosure.]

   c. More detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members. [This answer is correct. The audit plan is more detailed than the audit strategy and documents the audit procedures the auditor will perform to reduce audit risk to an acceptably low level.]

   d. Consists of (i) tests of details of classes of transactions, account balances and disclosures and (ii) substantive analytical procedures. [This answer is incorrect. This is the definition of substantive procedures.]

3. From the answer choices below, select the choice that best describes how an audit strategy is implemented. **(Page 269)**

   a. The audit strategy is an operational approach to achieving the objectives of the audit. [This answer is incorrect. While it is true that the audit strategy is an operational approach, this answer choice defines audit strategy without describing how an audit strategy is implemented.]

   b. The auditor first documents the audit procedures to be used, then establishes the nature and timing of the audit procedures and lastly determines the extent of testing necessary. [This answer is incorrect. This answer choice correctly identifies the steps in implementing an audit plan and not the audit strategy.]

   c. The auditor first accepts the engagement, then obtains an understanding of the entity, its environment and internal control and lastly, the auditor assesses the risk of material misstatement. [This answer is incorrect. This answer choice describes the implementation of general audit planning procedures.]

   d. The auditor first identifies the overall risks, then the overall responses to those risks and lastly the auditor decides upon the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. [This answer is correct. The general steps to implementing an audit strategy are contained in this answer choice.]

4. Listed below are descriptive titles for general and specific audit programs. Classify the titles between general and specific. **(Page 269)**

   i. General planning procedures

   ii. Basic procedures

   iii. Extended procedures

   iv. General auditing and completion procedures

   v. Audits of federal award programs

   vi. Other audit procedures

   a. General procedures: i, ii and iii. Specific procedures: iv, v and vi. [This answer is incorrect. According to SAS 108 (AU 311.20) although Audits of Federal Award Programs appears to be a specific audit program, it is a general audit program because it includes procedures for OMB Circular A-133 which affects audits of local governments.]

   b. General procedures: i, iv and v. Specific Procedures: ii, iii and vi. [This answer is correct. According to SAS 108 (AU 311.20) this answer choice correctly classifies the audit program titles between general and specific.]

   c. General procedures: iv, v and vi. Specific procedures: i, ii and iii. [This answer is incorrect. Although other audit procedures appears to be a general title for an audit program, it is actually a specific audit program.]

   d. General procedures: i, ii and v. Specific procedures: iii, iv and vi. [This answer is incorrect. This answer choice does not correctly classify the titles of the general and specific audit programs.]

5. From the audit program titles listed in Question 4 above, which one includes steps to supplement the Basic Procedures in response to the auditor's risk assessment at the relevant assertion level? **(Page 269)**

   a. General planning procedures. [This answer is incorrect. General planning procedures include such actions as engagement acceptance, assessing the risk of material misstatement, determining planning materiality and other actions which normally take place prior to the actual start of substantive analytical procedures.]

   b. Basic procedures. [This answer is incorrect. Basic procedures include substantive analytical procedures and tests of details usually required by the SASs.]

   c. Extended procedures. [This answer is correct. Extended procedures are audit procedures the auditor uses to supplement the basic procedures and are usually performed in response to the auditor's risk assessment at the assertion level.]

   d. Other audit procedures. [This answer is incorrect. Other audit procedures may include procedures requested by those charged with governance or may be as a result of the specific circumstances of the engagement.]

Specific Audit Programs

Audit programs for individual financial statement audit areas and specific types of engagements have a mixed approach that emphasizes the cycle approach for revenues and some expenditures but emphasizes balance sheet categories for other audit areas. The following organization of specific audit programs for individual financial statement audit areas and specific types of engagements is used in this course:

a. Cash and Investments.

   (1) Cash.

   (2) Investments.

b. Revenues and Expenditures.

   (1) Revenue, Receivables, and Receipts—Governmental Funds.

   (2) Service Revenue and Receivables—Proprietary Funds.

   (3) Expenditures/Expenses for Goods and Services and Accounts Payable and Other Liabilities.

   (4) Payroll and Related Liabilities.

c. Operating Assets, Debt, and Equity.

   (1) Inventories.

   (2) Capital Assets and Expenditures.

   (3) Debt and Debt Service Expenditures.

   (4) Fund Equities.

d. Insurance and Self-insurance.

e. Municipal Solid Waste Landfills.

f. Grant and Similar Programs.

   (1) Grant and Similar Programs.

   (2) Schedule of Expenditures of Federal Awards.

   (3) Federal Award Programs Not Included in the Compliance Supplement.

Effective Approach for Local Governmental Engagements

Typically the approach that tends to be most effective and efficient for the local governmental engagement is to use a mixed organization, and a standardized program that is tailored, where necessary, to the particular engagement. In a standardized program, the audit procedures are listed in the most logical sequence, and that improves efficiency. The standardized program provides a checklist or outline of the audit procedures to be applied, and an auditor can modify or tailor it to any unusual matters in a particular engagement. There is no reason that following a standardized program has to be mechanical. This risk is more a function of attitude, training, and supervision. The savings in effort and time gained by using standardized programs can free an auditor's attention for unusual or difficult situations that may arise.

The Concept of Financial Statement Assertions

The risk assessment standards retain the concept of assertions from previous standards as being the representations that management makes, implicitly or explicitly, regarding the recognition, measurement, presentation and disclosure of information in financial statements. The risk assessment standards, however, expand the categories of assertions used by the auditor and include three separate groups of assertions for (a) classes of transactions, (b) account balances, and (c) presentation and disclosure. The previous standards used essentially the same categories of assertions for classes of transactions and account balances; presentation and disclosure was a separate category of assertions.

Implementation of Assertion Categories. SAS No. 106, paragraph 16, states that the auditor may use the relevant assertions as they are described in the SASs or may express them differently provided aspects described therein have been covered. For example, the auditor may combine the assertions about transactions and events with the assertions about account balances. This means the auditor can continue to use generalized materials structured around broad categories of assertions.

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. To tailor the audit programs, the auditor first decides whether extended procedures are needed. To assist auditors in tailoring audit programs, PPC has developed *PPC's SMART Practice Aids*, which is an innovative audit tool that automatically generates audit programs based on the auditor's risk assessments.

Tailoring the Audit Programs

The key to effective auditing is selecting procedures for each audit area or assertion that correspond to its respective risks. Simply stated, this means spending more audit effort responding to the higher-risk areas or assertions and less audit effort in responding to the lower-risk areas or assertions. This lesson explains how to use audit programs for efficient auditing that meets the requirements of the risk assessment standards.

Lower-risk Audit Areas or Assertions. For lower-risk areas or assertions, the auditor believes there is little chance that a material misstatement will occur and, accordingly, expending significant amounts of effort to perform further audit procedures in these areas generally is unnecessary. Normally, limited procedures or basic procedures are sufficient. However, the determination of the need for further audit procedures is a matter of auditor judgment.

Higher-risk Audit Areas or Assertions. Generally, areas or assertions with a higher assessed risk of material misstatement require more assurance from substantive procedures. This is generally accomplished by supplementing the basic procedures with one or more extended procedures. The decision of which substantive procedures are appropriate to respond to a high risk of material misstatement is a matter of professional judgment.

Tailoring and Using the Audit Programs. The specific 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, as documented on a "Risk Assessment Summary Form." On that form, the auditor documents significant audit areas, the risks of material misstatement affecting each 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. The planned audit approach may be to perform limited procedures, basic procedures, or extended procedures. 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 of material misstatement at the assertion level. To assist auditors in tailoring audit programs, PPC has developed *PPC's SMART e-Practice Aids*, which is an innovative audit tool that automatically generates audit programs based on the auditor's risk assessments.

<u>Basic Procedures.</u> The basic procedures are generally sufficient when the risk of material misstatement has been assessed as low or moderate. These procedures are often supplemented in higher risk areas by extended procedures (procedures for additional assurance). Basic procedures, by themselves, are not ordinarily appropriate for responding to a fraud risk or other significant risk.

<u>Selecting Extended Procedures (Procedures for Additional Assurance).</u> If the auditor decides that extended procedures are needed, the next step is to decide which procedure(s) should be performed. 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 specific 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 or circling the assertion(s) for which the additional assurance is needed. For example, auditors who identify a significant risk relating to the completeness of capital assets can scan the list of procedures for additional assurance in an "Audit Program for Capital Assets and Expenditures," looking for procedures relating to completeness. If an appropriate procedure is identified, 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 circle the "C" in the assertion column to 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 feels that the risk of material misstatement is still present after performing procedures or if there is not a procedure in the audit program that responds to the identified risk, the auditor should develop an appropriate response.

Even high-risk areas or assertions can be overaudited. Only rarely would an auditor need to perform all the extended procedures for an audit area. The auditor should focus on the extended procedures that relate to the risks identified for that area and, as previously noted, the auditor should select additional procedures based on the assessment of risk of material misstatement at the relevant assertion level. In some cases, only one additional procedure may be necessary. At other times, two or more procedures might be needed.

When the auditor is selecting extended procedures, the goal should be to find the appropriate mix of analytical procedures and tests of details to respond to the risk of material misstatement. For high risk areas or assertions, the auditor generally chooses extended procedures to supplement the basic procedures. However, sometimes a selected step in the Extended Procedures section might replace a step 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.

Specialized Considerations for Governmental Units

According to AU 311.09, the auditor must develop an audit plan that documents the audit procedures to be used that are expected to reduce audit risk to an acceptably low level. Because governmental financial statements typically have multiple opinion units, audit procedures may be most efficient when they are designed to test several opinion units and thus, avoid repetitive procedures. However, if the government operates one or more activities separately or autonomously, it may be necessary to design and perform separate audit procedures for those activities.

Most governments maintain their accounting records based on funds and then separately develop information for the government-wide financial statements. As a result, it is generally more efficient to first focus audit procedures on the fund financial statements. However, the auditor must still obtain a sufficient understanding of the processes and internal controls over the additional information developed for the government-wide financial statements and apply audit procedures to that information.

Financial Statement Reconciliations. To a large extent, the additional information developed for government-wide statements is explained in reconciliations presented on the face of applicable fund financial statements or in accompanying schedules.

Customizing Audit Programs. The auditor should customize audit programs to fit the particular governmental engagement. Additional tailoring may be necessary to accommodate specific client circumstances and to recognize differences in local statutes, ordinances, and similar unique characteristics. In this context, *governmental unit* is a convenient term for the financial reporting entity the auditor is auditing and reporting on. Thus, it includes the primary government and any component units that should be included.

<u>Legal and Administrative Differences.</u> There are many differences in governments throughout the United States caused by differences in state statutes, local ordinances, other applicable laws and regulations, and government specific administrative characteristics. These differences need to be considered in adapting the audit programs to the particular circumstances of the governmental unit under audit. Terminology used in this course is general and can be adapted to a variety of specific circumstances. "Governing body" is used to identify the legislative branch of government that is generally responsible for adoption of budgets and financial and operating policy. The term *responsible officials* is used to identify the administrative officers or employees of the executive branch of government responsible for implementation and execution of policies.

<u>Variations in Terms.</u> Some terms used in audit programs may have to be modified to recognize local variations. For example, the term *treasurer's record of cash* is used to identify centralized cash records. These records may be maintained by other officials and described in various terms depending on the jurisdiction. If a centralized treasury or the equivalent is not used, cash receipts would be traced to deposit in the appropriate depository account. Other variations may occur in arrangements for assessment, billing, and collection of various taxes and in legal arrangements related to issuance and repayment of debt. It may be necessary to adapt the audit programs for such requirements.

Responsibility for Fraud Detection

The auditor is responsible for designing the audit to detect material misstatements, whether caused by error or fraud. The auditor does not select procedures designed specifically to detect fraud in ordinary circumstances. However, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU 316), requires the auditor to specifically identify and assess risks of material misstatement due to fraud and to respond to the results of that assessment when gathering and evaluating audit evidence.

A risk of misappropriation of assets will exist in many governmental units. However, the auditor is not responsible for immaterial fraud, and many frauds involving misappropriation of assets are not material to the financial statements. Consequently, auditors need not automatically perform additional procedures related to misappropriation simply because a risk of misappropriation exists. The auditor should consider the level of risk that material misappropriation has occurred.

SAS No. 99 (AU 316) requires auditors to ordinarily presume that improper revenue recognition is a risk that may result in material misstatement of the financial statements due to fraud. AU 316 indicates that account balances or classes of transactions that are particularly susceptible to manipulation, such as those involving significant estimates or the application of complex accounting principles, may present risks of material misstatement due to fraud. In addition, even if the auditor does not identify specific risks of material misstatement due to fraud, the auditor is required to perform 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 auditor should identify risks relating to specific opinion units and should consider whether it is necessary to identify risks relating to specific operating locations as well as to the government as a whole.

Based on the assessment of fraud risks, the auditor may alter the nature of procedures (i.e., apply additional procedures designed to detect fraud), or alter the timing or extent of procedures. The auditor also may require more or different evidence to support material transactions or balances than would be the case if no specific fraud risks were identified.

The audit procedures in this course are designed to respond to the auditor's assessment of the risk of material misstatement due to fraud for a financial statement audit. They provide some of the more common additional procedures that may be performed in response to the auditor's fraud risk assessment. If the auditor either believes fraud has occurred or is performing a fraud investigation, the auditor might refer to *PPC's Guide to Fraud Detection* for more extensive fraud detection procedures and practice aids to assist in performing a fraud investigation.

Responsibility for Detection of Illegal Acts

SAS No. 54, *Illegal Acts by Clients* (AU 317), states that the auditor's responsibility for detecting misstatements resulting from illegal acts that have a direct and material effect on the financial statements is the same as that for other errors and fraud. However, the auditor does not design the audit to detect indirect-effect illegal acts.

As part of audit planning, the auditor should make inquiries of management about compliance with laws and regulations. Where applicable, the auditor should also inquire about (a) policies related to the prevention of illegal acts and (b) the use of directives (for example, a code of ethics) and obtaining periodic representations from management-level employees about compliance with laws and regulations. Responses to these inquiries can be documented using a "Fraud Risk Inquiries Form" or "Audit Inquiries Summary Form". If an illegal act is detected during the audit, SAS No. 54 requires that it be communicated to those charged with governance, unless clearly inconsequential.

Specialized Considerations for Fraud, Illegal Acts, Noncompliance, and Abuse in an Audit of a Governmental Unit

GAAS Requirements Related to Compliance with Laws and Regulations. Illegal acts are defined in AU 317.02 as violations of laws or governmental regulations. SLG, paragraph 4.79, states that even though "it has not been explicitly stated in AU section 317, the phrase *laws and governmental regulations* generally has been interpreted to implicitly include the provisions of contract and grant agreements." This course sometimes collectively refers to laws, regulations, and the provisions of contracts and grant agreements as *compliance requirements*, and to illegal acts and violations of contracts and grant agreements as *noncompliance*.

In the audit of a governmental unit, substantial attention is given to compliance with laws and regulations. Although management is responsible for ensuring that the governmental unit complies with laws and regulations applicable to its activities, the auditor is responsible for considering laws and regulations and how they affect the audit. Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Such procedures for financial statement audits are performed in accordance with AU 317.

AU 317 is not applicable in a *compliance audit* that is performed under AU 801. According to SAS No. 117 (AU 801), *Compliance Audits*, a compliance audit is a program-specific audit or an organization-wide audit of compliance with applicable compliance requirements that is performed in accordance with GAAS, *Government Auditing Standards*, and a governmental audit requirement that requires the auditor to express an opinion on compliance, such as the OMB Circular A-133 requirement. An appendix to SAS No. 117 lists AU sections that are not applicable in a compliance audit either because (a) they are not relevant to a compliance audit, (b) they would not contribute to meeting the audit objectives, or (c) the subject matter is specifically covered by AU 801. AU 317 is listed in that appendix as not applicable in a compliance audit.

***Government Auditing Standards* Requirements.** Among other things, *Government Auditing Standards* establish additional requirements related to (a) noncompliance with contracts and grant agreements, (b) abuse, and (c) communication of fraud, illegal acts, noncompliance, and abuse.

Government Auditing Standards states that auditors should design their audits to provide reasonable assurance of detecting noncompliance with the provisions of contracts or grant agreements that could have a direct and material effect on the financial statements. The Yellow Book, at Paragraph 4.11, states that the auditors should apply additional procedures if evidence of possible violations of provisions of contracts or grant agreements comes to the auditor's attention. If the auditor subsequently concludes that a violation has occurred or is likely to have occurred, the auditor should determine the implications for other aspects of the audit, as well as the effect on the financial statements.

Government Auditing Standards also establish requirements related to abuse. The concept of abuse is different from that of fraud, illegal acts, or noncompliance. The Yellow Book indicates that abuse "involves 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. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate." It may or may not involve fraud, illegal acts, or noncompliance with contracts or grant agreements.

In Appendix I, Paragraph A.06, the Yellow Book provides the following examples of actions that may represent abuse, depending on the relevant facts and circumstances:

a. Creating unneeded overtime.

b. Requesting staff to perform personal errands or work tasks for a supervisor or manager.

c. Misusing the official's position for personal gain (including actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an official's personal financial interests or those of an immediate or close family member; a general partner, an organization for which the official serves as an officer, director, trustee, or employee; or an organization with which the official is negotiating concerning future employment).

d. Making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.

e. Making procurement or vendor selections that are contrary to existing policies or are unnecessarily extravagant or expensive.

Because an audit of a government's financial statements is based on opinion units, the auditor's consideration of abuse should address each opinion unit. However, the determination of abuse can be very subjective. Thus, auditors are not required to provide reasonable assurance of detecting abuse. Instead, Paragraph 4.13 of the Yellow Book states that if auditors become aware of abuse that could be material (either quantitatively or qualitatively), they should perform additional procedures to determine its potential effect on the financial statements or other financial data significant to the audit objectives. These additional procedures may lead the auditor to conclude that the abuse represents potential fraud or illegal acts.

The Yellow Book also provides specific requirements for auditors to communicate fraud, illegal acts, noncompliance, and abuse, including requirements for reporting to outside parties in certain situations.

SELF-STUDY QUIZ

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

6. Describe the approach for selecting an audit program (either standardized or unique) when preparing for a local government audit engagement that will be most effective and efficient and explain why.

   a. Use a standardized program that is tailored, where necessary, to the particular client because a standardized program improves efficiency by listing audit procedures in the most logical sequence.

   b. Use a standardized program because a standardized program tends to produce a mechanically efficient audit.

   c. Use a unique program because a unique program insures that all audit procedures are included in the audit.

7. Considering the risk assessment standards and the concept of financial statement assertions, which of the following properly defines the concept of financial statement assertions?

   a. Financial statement assertions are made by the auditors and include such categories of risk assessment, test of controls and substantive procedures.

   b. Financial statement assertions are made by management and may include a statement such as, "Financial statements are presented in accordance with GAAP."

   c. Financial statement assertions are representations the auditor makes when the auditor determines the nature, timing and extent of substantive procedures.

   d. Financial statement assertions are representations management makes, implicitly or explicitly, regarding the recognition, measurement, presentation and disclosure of information in financial statements.

8. Select the answer choice that best defines how financial statement assertions contribute to an effective audit. To perform an effective audit:

   a. The auditor expends significant amounts of effort performing further audit procedures in lower-risk areas or assertions.

   b. The auditor does not supplement the basic procedures with extended procedures especially in higher-risk areas or assertions.

   c. The auditor selects procedures for each assertion that correspond to the respective risks associated with each assertion.

   d. The auditor uses a "Risk Assessment Summary Form" to document significant audit areas and then performs limited procedures for those audit areas which are significant.

9. The auditor has a responsibility to design the audit to assess risks of material misstatement due to fraud and should respond to the results of the assessment when gathering and evaluating the audit evidence.

   a. True.

   b. False.

10. With respect to abuse, the Yellow Book—

    a. Details auditor responsibilities for reporting abuse.

    b. Interprets contracts and grant agreements in a uniform way.

    c. Withholding communication from the governmental unit's management if he becomes aware that the unit may be subject to an audit requirement not included in the terms of the engagement due to it changing the scope of the audit.

    d. Interprets contracts and grant agreements in uniform way.

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. Describe the approach for selecting an audit program (either standardized or unique) when preparing for a local government audit engagement that will be most effective and efficient and explain why. **(Page 276)**

   a. Use a standardized program that is tailored, where necessary, to the particular client because a standardized program improves efficiency by listing audit procedures in the most logical sequence. [This answer is correct. By using a standardized program that is modified for any unusual matters in a particular engagement, the auditor achieves efficiency and effectiveness by having an outline of audit procedures to be applied and the ability to focus on difficult situations that may arise.]

   b. Use a standardized program because a standardized program tends to produce a mechanically efficient audit. [This answer is incorrect. There is a risk that using a standardized audit without adequate supervision will be mechanical. A mechanical audit process will not be effective although it may be efficient.]

   c. Use a unique program because a unique program insures that all audit procedures are included in the audit. [This answer is incorrect. When using a unique program approach to auditing a local government, there is a risk that an audit procedure will be omitted from the program. This will result in an ineffective audit.]

7. Considering the risk assessment standards and the concept of financial statement assertions, which of the following properly defines the concept of financial statement assertions? **(Page 276)**

   a. Financial statement assertions are made by the auditors and include such categories of risk assessment, test of controls and substantive procedures. [This answer is incorrect. Although the risk assessment standards expanded the categories of assertions used by the auditor, the items included in this answer choice are audit procedures rather than a group of assertions the auditor would use.]

   b. Financial statement assertions are made by management and may include a statement such as, "Financial statements are presented in accordance with GAAP." [This answer is incorrect. This answer choice provides an example of an audit objective rather than a financial statement assertion.]

   c. Financial statement assertions are representations the auditor makes when the auditor determines the nature, timing and extent of substantive procedures. [This answer is incorrect. This answer choice lists the determination the auditor must make that is necessary to obtain appropriate audit evidence.]

   d. Financial statement assertions are representations management makes, implicitly or explicitly, regarding the recognition, measurement, presentation and disclosure of information in financial statements. [This answer is correct. This answer choice correctly defines the financial statement assertions made by management. The risk assessment standards expanded the categories of assertions used by the auditor, so auditors also make financial statement assertions.]

8. Select the answer choice that best defines how financial statement assertions contribute to an effective audit. To perform an effective audit: **(Page 277)**

   a. The auditor expends significant amounts of effort performing further audit procedures in lower-risk areas or assertions. [This answer is incorrect. By expending an audit effort to perform further audit procedures in lower-risk areas, the auditor is being inefficient and most likely overauditing.]

   b. The auditor does not supplement the basic procedures with extended procedures especially in higher-risk areas or assertions. [This answer is incorrect. This answer choice presents exactly the opposite of the actions an effective auditor would perform.]

   c. The auditor selects procedures for each assertion that correspond to the respective risks associated with each assertion. [This answer is correct. By using a method which links the assessed risks to audit procedures that respond to those risks, the auditor applies an appropriate audit effort to higher-risk areas or assertions.]

   d. The auditor uses a "Risk Assessment Summary Form" to document significant audit areas and then performs limited procedures for those audit areas which are significant. [This answer is incorrect. The "Risk Assessment Summary Form" is the best method for linking the assessed risks with the audit procedures to respond to those risks. An effective auditor would perform extended procedures in those areas which present a significant risk.]

9. The auditor has a responsibility to design the audit to assess risks of material misstatement due to fraud and should respond to the results of the assessment when gathering and evaluating the audit evidence. **(279)**

   a. True. [This answer is correct. The auditor is responsible for designing the audit to detect material misstatements, whether by error or by fraud. The auditor is also responsible for establishing the materiality of the misstatement once the fraud or error is discovered.]

   b. False. [This answer is incorrect. While the auditor does not select procedures designed to specifically detect fraud, the auditor should be accountable to plan an audit that would assess the risks of material misstatements by either error or fraud.]

10. With respect to abuse, the Yellow Book— **(Page 280)**

    a. Details auditor responsibilities for reporting abuse. [This answer is correct. The Yellow Book provides guidance for reporting abuse.]

    b. Interprets contracts and grant agreements in a uniform way. [This answer is incorrect. The breaking of a law is not a requirement of abuse as defined in the Yellow Book.]

    c. Interprets contracts and grant agreements in uniform way. [This answer is incorrect. What constitutes abuse as defined by the Yellow Book is open to interpretation and auditor judgment.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (ALGTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Explain how the audit strategy is different from the audit objective.

   a. The audit strategy is the auditor's operational approach to achieving the audit objective.

   b. The audit objective is the auditor's operational approach to achieving the audit strategy.

   c. The audit strategy documents the achievement of the audit objective.

   d. The audit objective documents the achievement of the audit strategy.

2. Alexy, a partner in a small firm, has completed the following steps with regard to the audit of New Bedlam Township: accepted the engagement, obtained an understanding of the entity, its environment and internal control and assessed the risk of material misstatement. What do these steps represent?

   a. The implementation of an audit strategy.

   b. The completion of the first level of general planning procedures.

   c. The development of an audit plan.

   d. The obtainment of sufficient appropriate audit evidence.

3. Which of the following properly describes a trait of specific audit programs?

   a. The cycle approach is emphasized for all audit areas.

   b. The cycle approach is emphasized for revenues only.

   c. The cycle approach is emphasized for revenues and some expenditures and the balance sheet categories is emphasized for other audit areas.

   d. The cycle approach is emphasized for revenues but not expenditures and the only balance sheet category receiving audit emphasis is current assets.

4. A specific audit program generally starts with basic procedures when the auditor is planning the audit. The basic procedures can be enhanced with additional procedures if the auditor has determined that the risks are higher based on assessment.

   a. True.

   b. False.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

5. Substantive procedures consist of:

   a. An overview of transactions, account balances and disclosures.

   b. A detailed assessments of risks.

   c. Analytical procedures and tests of details.

   d. Do not select this answer choice.

6. Lu Newby, an inexperienced staff auditor is looking at a "Risk Assessment Summary Form" and attempting to determine the correct order of steps in completing the form. Help Lu by selecting the answer choice below that describes the steps for completing the form in the proper order.

    i. The auditor documents significant audit areas.

    ii. The risks of material misstatement affecting each audit area are documented.

    iii. The assessment of risks of material misstatement at the assertion level are documented.

    iv. The planned audit approach is appropriately tailored to respond to the assessed level of risk is documented.

    v. The documentation of the linkage of the assessed risks to the audit procedures that respond to those risks is made on the form.

    a. i, ii, iii, iv and v.

    b. ii, iii, i, iv and v.

    c. v, iv, iii, ii and i.

    d. iv, v, i, ii and iii.

7. Considering basic procedures and extended procedures, which of the following statements is most accurate?

    a. It is not possible to overaudit high-risk areas or assertions.

    b. Basic procedures, used alone, are not ordinarily appropriate for responding to fraud risk.

    c. The auditor must first apply all procedures in the basic procedures section before applying extended procedures.

    d. The auditor first selects the extended procedure to apply and then determines if extended procedures are necessary.

8. Select one reason why it might be necessary to customize the basic audit program to fit the particular government engagement. To accommodate:

    a. the need to apply additional procedures based on the risk assessment documented.

    b. the need to apply additional procedures based on information obtained by performing audit procedures the results of which alter the auditor's judgment about the assessed risk.

    c. an evaluation of whether procedures performed provide sufficient assurance.

    d. specific client circumstances and recognize differences in local ordinances and state statutes.

9. Alfred Euclid, an audit manager with many years experience auditing local governments has designed, what he believes, to be an efficient and effective audit program. What is Alfred's primary responsibility when he was designing the audit program?

    a. To design the audit program so the audit detects fraud.

    b. To design the audit program so that the audit will detect material misstatements.

    c. To mitigate the risk that misappropriation of assets may occur and not be detected.

    d. Do not select this answer choice.

10. During a governmental audit, considerable attention is allotted to complying with laws and regulations. Which is the audit team's primary concern?

    a. Detecting errors and fraud in the financials.

    b. Designing the audit to provide assurance that the financial statements are free from all misstatements.

    c. Considering the laws and regulations and how they affect the audit.

    d. Whether the governmental unit complied with laws and regulations applicable to its activities.

Lesson 2: Auditing the Financial Statement Accounts

INTRODUCTION

This lesson discusses the relevant assertions for the various financial statement accounts. Once the relevant assertions are made, the auditor selects substantive audit procedures for the accounts under audit and develops an audit program. This lesson also discusses the relevant accounting and disclosure considerations.

Learning Objectives:

Completion of this lesson will enable you to:

- Develop the relevant assertions for various accounts, including cash, investments, revenues, expenditures, operating assets, debt and equity.
- Select substantive audit procedures for various accounts, including cash, investments, revenues, expenditures, operating assets, debt and equity.
- Prepare an audit program for various accounts.
- Apply the accounting and disclosure considerations relevant to local government financial statements.

The audit approach to cash and to investments is very similar to that used for business enterprises. However, some specific procedures are necessary to recognize the importance of compliance with laws and regulations and to accommodate the operating characteristics of governmental units. Governmental units are required to disclose the types of investments they are legally authorized to make and any significant violations of legal or contractual provisions for deposits and investments. The auditor has to evaluate a governmental unit's compliance with these provisions. Thus, it is important for the auditor to evaluate whether depositories and investment counterparties are legally acceptable; whether depository institutions maintain specified and adequate collateral; and whether investments are of the types authorized by law and the investment policy of the governmental unit.

SAS No. 54 discusses the auditor's responsibility for detecting illegal acts that have a direct and material effect on the financial statements. However, the auditor might become aware of noncompliance related to cash and investments that could have a material *indirect* effect, such as insufficient collateral on depository accounts; the use of unauthorized depositories or investment counterparties; the use of unauthorized investment types or terms; unauthorized use of derivatives, and other sophisticated investments reverse repurchase agreements, or securities lending transactions; not using separate accounts for individual funds when required; or the use of internal investment pools when not authorized or not consistent with the investment objectives of the funds involved. If noncompliance that has a material indirect effect on the financial statements is identified, the auditor should consider whether that noncompliance has been properly disclosed in the notes to the financial statements. If it has not been properly disclosed, the auditor should consider the effect on the auditor's report and communicate the noncompliance to those charged with governance in accordance with SAS No. 54.

Specialized Considerations for Governmental Units

Auditing Based on How Cash and Investment Portfolios are Managed. In auditing cash and investments of a governmental unit, it is often more efficient and effective to apply procedures based on a portfolio approach, (i.e., the manner in which the government manages its portfolios) instead of by individual fund. However, when applying a portfolio approach, the auditor should make sure that adequate procedures are performed related to activity and balances in each opinion unit that has material cash and investments.

Cash

Cash includes currency and checks on hand and demand deposits with banks and other financial institutions. For the purpose of GASBS No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, cash also includes deposits in accounts and pools that have the characteristics of demand deposit accounts that allow deposits and withdrawals to be made at any time without prior notice or penalty.

GASBS No. 3 does not define the term "deposits." However, the *GASBS Comprehensive Implementation Guide—2009*, Question 1.2.1, explains that deposits to which GASBS No. 3 applies include the following deposits in banks, savings associations, and credit unions:

a. *Demand, Savings, and Time Accounts.*

b. *Negotiable Orders of Withdrawal (NOW) Accounts.*

c. *Nonnegotiable Certificates of Deposit (CDs).* Most CDs held by governments are nonnegotiable. Although governments often classify nonnegotiable CDs as investments in the balance sheet, they are considered deposits for the purpose of applying GASBS No. 3. (Negotiable CDs are considered investments for the purpose of applying GASBS No. 3.)

d. Governments that participate in deposit placement services should consider CDs acquired from other banks as a result of this service to be deposits, as discussed in the GASB *Comprehensive Implementation Guide—2009*, Question 1.30.17.

e. *Money Market Accounts at Financial Institutions.* The GASB Comprehensive Implementation Guide—2009, Question 1.40.1, makes a distinction between money market accounts at financial institutions and open-end and closed-end mutual funds. Money market accounts at financial institutions are considered deposits for the purpose of applying GASBS No. 3. Mutual funds are not considered to be deposits.

f. *Bank Investment Contracts (BICs).* These and similar contracts at other types of financial institutions, such as savings and loan investment contracts (SLICs), are treated as deposits even though they are considered to be interest-earning investment contracts for purposes of applying GASBS No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. (See the discussion beginning at paragraph 901.49.) Note, however, that the GASB *Comprehensive Implementation Guide—2009*, Questions 1.41.1 and 1.54.1, states that guaranteed investment contracts (GICs) are not treated as deposits for purposes of deposit custodial credit risk disclosure because they are not deposits at financial institutions.

Relevant Assertions for Cash. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. For example, valuation may not be relevant to cash accounts unless currency translation is involved (which is unlikely in a small government). However, existence and completeness are always relevant for cash. The relevant assertions for cash of each opinion unit are as follows:

- Existence or occurrence (E/O)—Reported cash represents amounts that are on-hand, in-transit, or in the custody and safekeeping of others on behalf of the entity. Reported cash flow activity represents amounts related to the period and pertains to the entity. Disclosed events and transactions have occurred and pertain to the entity.

- Completeness (C)—All cash flow activity applicable to the period and all cash balances have been reported. All required disclosures have been included in the financial statements.

- Rights or obligations (R/O)—Conditions and agreements that affect the entity's rights and obligations concerning cash have been properly reflected in the financial statements.

- Accuracy or classification (A/CL)—Cash flow activity has been recorded at appropriate amounts and reported in appropriate categories. Cash transaction have been included in the financial statements at appropriate amounts. Cash and cash flow activity have been appropriately presented and described, and are disclosed fairly and at appropriate amounts in accordance with GAAP. Disclosures are clearly expressed.

- Cutoff (CO)—Cash transactions have been recorded in the correct accounting period.

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

Substantive Audit Procedures for Cash. The substantive audit procedures for cash primarily focus on obtaining assurance about the reliability of the governmental unit's bank reconciliation, which provides audit evidence about existence/occurrence, completeness, accuracy/or classification, and cutoff. Auditors often confirm the balance of selected cash accounts as the primary test of the existence assertion as well as to obtain evidence about rights/obligations. However, if the client has one or two primary accounts and numerous secondary accounts that have minimal activity, confirmations might only be requested for the primary accounts. For the accounts not confirmed, the bank balances shown on the bank reconciliation can simply be agreed to the bank statement. (Cash confirmations are not required by GAAS, *Government Auditing Standards*, or OMB Circular A-133.) Further, SAS No. 67 (AU 330.10) notes that depending on the combined assessed level of inherent and control risk over the existence of cash, the auditor might limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.

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

In addition to reviewing confirmations received from financial institutions, auditors might also review loan and debt agreements, governing board minutes, and other documentation, make inquiries of management; and perform other auditing procedures to obtain evidence about the following matters:

- Guarantees, endorsements and/or letters of credit, including guarantee arrangements for related parties.
- Whether amounts are appropriately classified as cash, cash equivalents, or other short-term investments.
- Whether overdrawn cash balances are correctly reported as liabilities instead of negative cash balances.
- Whether the allocation of pooled cash balances and transactions is reasonable, accurate, in conformity with GAAP, and properly classified and disclosed in the financial statements.
- Whether the statement of cash flows uses the direct method, properly reports cash flows as gross or net, properly classifies cash receipts and payments, reconciles operating income to net cash flow from operating activities, and discloses noncash investing and financing activities.
- Whether the governmental unit is in compliance (during the year and at year-end) with compliance requirements that could have a direct and material effect on the determination of financial statement amounts, such as those relating to:
    - Legal or contractual provisions that require separate bank accounts for certain amounts.
    - Cash restrictions, including withdrawal restrictions and minimum balance requirements.
    - Designations of amounts for special purposes.
    - Types of deposits authorized by legal and contractual provisions and, if applicable, any violations of those provisions during the period.
- Whether deposits are appropriately collateralized and, if applicable, the portion of bank balances for which there is custodial credit risk at year end.

- Whether procedures for establishing and complying with deposit risk policies are adequate.
- Whether cash disclosures are in conformity with GAAP and include all appropriate balances, including balances held by fiduciary funds.

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

Audit Program for Cash. A core audit program presents basic and extended audit procedures for cash. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for cash that are normally adequate to respond to a set of underlying risk assessments considered typical of many governments.

Starting the Cash Program. The auditor should identify all depositories, including banks from which certificates of deposit and Treasury bills were purchased, and those with which the governmental unit has transacted business during the period under audit. In addition, because of compliance concerns, the auditor needs to determine that separate bank accounts when required by a legal or contractual provisions are maintained when required by a legal or contractual provisions.

Bank Confirmations. The detailed work for cash is virtually the same as for a business enterprise of similar size. The basic approach is to confirm the balance as of the date of the balance sheet and determine that the governmental unit's cash records agree with depositories' records by applying audit procedures to the bank reconciliations. A confirmation form titled "Standard Form to Confirm Account Balance Information with Financial Institutions" is limited to confirming only deposit and loan balances that the client has identified. The auditor should ascertain that as much information as possible is provided on the form to identify the deposit or loan balance being confirmed. The form requests financial institutions to indicate any exceptions to the information noted and to confirm any additional account or loan balance information that comes to their attention during the process of completing the form.

Special Considerations for Electronic Bank Confirmations. Some banks no longer respond to paper confirmation requests. Instead, they will respond only to electronic confirmation requests submitted via a designated third-party provider. The use of paper confirmation requests in this situation may result in delays to the confirmation process and completion of the audit.

An auditing interpretation, *Use of Electronic Confirmations* (AU 9330.01–.08), indicates that electronic confirmations may provide reliable audit evidence. When using electronic confirmations, auditors should consider the following risks related to the reliability of such information:

- The response might not be from an authentic source.
- The respondent might not be knowledgeable about the information.
- Integrity of the transmission might be compromised.

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

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

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

During engagement planning, the auditor should consider whether the client's financial institution requires the use of a third-party confirmation service. By doing so, the auditor (a) will have appropriate time to learn about the service, (b) can determine whether the service addresses the risks discussed above, and (c) can discuss modifications in the confirmation process with the client.

Currently, Capital Confirmation, Inc. has been designated as the third-party provider for submitting electronic confirmation requests for certain financial institutions. Additional information on Capital Confirmation, Inc. can be obtained from their website at **www.capitalconfirmation.com**.

Confirmation of Cash Restrictions. In auditing governmental entities, the auditor needs to consider the propriety of the financial statement classification of cash balances and the adequacy of disclosure of restrictions, such as minimum balance requirements related to debt agreements. A separate written request, signed by the client, should be used to confirm arrangements such as minimum balance requirements, lines of credit, and oral and written guarantees. Best practices are to send the confirmation to a specific financial institution official who is responsible for the financial institution's relationship with the client or who is knowledgeable about the transactions or arrangements. Since some financial institutions centralize this function, the auditor will need to ascertain the appropriate recipient. Some auditors also believe it is worthwhile to confirm authorized check signers on governmental engagements, especially if state statutes or local regulations specify signature requirements. A form, "Confirmation of Authorized Signatories," can be used for that purpose.

Canceled Checks. Auditors often use canceled checks when testing bank reconciliations or examining support for transactions in other audit areas. However, banks no longer have to return canceled checks. Some banks have started returning check images or substitute checks with all the "force and effect" of the original cleared checks. However, if the auditor cannot obtain canceled checks, check images, or substitute checks, the following alternative procedures may provide sufficient audit evidence about disbursements:

a. Some banks list the payee on the bank statement as well as the check number, amount, and date paid. This detail may provide sufficient evidence of the actual payee listed in the government's records.

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

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

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

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

    (3) Designation of authorized check signers.

    (4) Restricted access to checks and signature plates.

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

Pooled Cash. Governmental units frequently pool the cash accounts of several funds. However, each fund, activity, and component unit should report its own cash, including its amount of pooled cash. The GASB *Comprehensive Implementation Guide—2009*, Question 6.29.3, explains that equity positions in internal pools should be reported, for example, as "equity in cash management pool" or "cash and cash equivalents." If one fund overdraws its share of the pooled cash account, the fund should report an interfund liability to whatever fund the management of the governmental unit deems to have "loaned" the cash to the overdrawn fund. The fund that is deemed to have loaned the cash reports an interfund receivable from the borrowing fund. This accounting treatment is necessary whether the funds involved are of the same or different fund types. If a pooled cash account is overdrawn in total, the balance should be reported as a fund liability. Although cash is frequently pooled, some individual funds may be required by law or contract to maintain separate bank accounts. This should be determined in identifying bank accounts at the start of the audit of cash.

Restricted Cash. It sometimes is necessary to classify certain cash as restricted, for example, to meet compliance requirements such as debt covenants. Assets are reported as restricted when the nature and amount of those assets satisfy legal or contractual requirements. When compliance requirements indicate that certain cash should be classified as restricted, the auditor's procedures might include evaluating the adequacy of the government's compliance with the restrictions, including reporting of the restrictions. For example, if the auditor finds that assets restricted for debt retirement include amounts due from other funds, there is an implication that the underlying assets have not been appropriately restricted. Thus, the government would not be in compliance with the requirement for restriction of the assets.

A debt service fund typically uses a fiscal agent to make interest and principal payments to bondholders. The debt service fund transfers cash to the fiscal agent, who holds it until the payments are made. The cash is considered the government's until the agent disburses it, but its use is restricted. If the agent is holding such cash at the balance sheet date, the debt service fund may report the cash on a separate line of the balance sheet as "cash with fiscal agent" or "cash with escrow agent." The line may be shown as a separate component under a restricted assets caption. Sometimes, the portion of cash with a fiscal agent is not separately displayed in the balance sheet but is disclosed in the notes instead.

Warrants. In the cash area or in the accounts payable area, the auditor may encounter the term *warrant*. In governmental accounting, a *warrant* is an order drawn by a legislative body or a responsible government official on the government's treasurer directing the treasurer to pay a specified amount to a specified person or to the bearer. A warrant may be payable on demand and, in that case, is the same as a bank check and reduces cash. A warrant may also be payable only out of certain revenues when and if those revenues are received and, in that case, is recorded as a warrant payable.

Deposit Collateral and Insurance. An unusual feature of governmental engagements is the need to be concerned with collateral pledged to secure deposits. State statutes often require that cash deposits in excess of deposit insurance be collateralized by the depository institution. When this is the case, the depository institution pledges specified types of securities as collateral, some states require collateral pledges equal to 100% to 125% of the uninsured deposits.

The auditor needs to stay quite current with the collateralization laws and determine the existence and value of collateral throughout the year as well as at year end. There may be local differences in the level of collateral required, the type of security that may be pledged, and the location and treatment of collateral securities. In addition, collateral requirements may change in response to economic conditions. Best practices indicate that the auditor obtain from the finance director's records a schedule of collateral pledged to secure deposits, including (a) the name of the depository, (b) a description of the collateral, and (c) the amount of collateral. In determining the extent of collateralization, the market values of the collateral securities should be used, not the par values. The auditor might examine collateral pledged to secure deposits or confirm the collateral with banks and agencies holding the pledged collateral securities, and should determine if the collateral complies with legal requirements.

To determine whether deposits exceed depository insurance, the auditor needs to be aware of the pertinent FDIC regulations. Paragraph 330.15 of Section 2000 of FDIC RULES AND REGULATIONS addresses public unit accounts and can be found at **www.fdic.gov/regulations/laws/rules/ 2000-5400.html#2000part330.15**. Time and savings accounts owned by a state, county, municipality, or a political subdivision thereof and deposited by the same official custodian in an insured bank within the state in which the governmental unit is located are added together and insured up to a legally-established maximum. Demand deposit accounts owned by a state, county, municipality, or a political subdivision thereof and deposited by the same official custodian in an insured bank within the state in which the governmental unit is located are also insured to a maximum of legally-established. If funds are deposited by the same official custodian in an insured bank outside the state in which the governmental unit is located, the insurance coverage is is based on aggregate for time, savings, and demand deposits.

Until October 2008, the maximum amount covered by FDIC insurance was $100,000. The Emergency Economic Stabilization Act of 2008 temporarily raised the basic limit on federal deposit insurance coverage to $250,000 per depositor (for governments, the limit is per "official custodian"). The limit will return to $100,000 after December 31, 2013. In addition, a new FDIC program, the Transaction Account Guarantee Program, provides for a guarantee through June 30, 2010, of all amounts in excess of $250,000 held in noninterest-bearing transaction accounts at FDIC-insured institutions that agree to participate in the program. *Noninterest-bearing transaction accounts* are defined as transaction accounts "with respect to which interest is neither accrued nor paid and on which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal." This definition covers traditional demand deposit checking accounts that allow for an unlimited number of deposits and withdrawals at any time. The new rules related to FDIC coverage are complex and can vary from institution to institution. Best practices are for auditors to read the information available on the FDIC website at **www.fdic.gov/deposit/deposits/changes.html** and, if the amount of the governmental unit's deposits so warrants, inquire of officials of the financial institution about the extent of FDIC insurance coverage and whether it is participating in the Transaction Account Guarantee Program.

FDIC regulations provide that the official custodian of the funds belonging to the governmental unit (e.g., the city finance director) and not the governmental unit itself is insured as the depositor. An official custodian is an officer, employee, or agent of a state, county, municipality, or public subdivision thereof having official custody of public funds and lawfully depositing the funds in an FDIC-insured bank. An individual who is not vested with the authority to serve as lawful custodian would not be entitled to the insurance coverage. Also, a governmental unit cannot increase coverage merely by fragmenting authority over its funds among several so-called official custodians. If authority for public funds is under dual control (i.e., two officials have custody), the officials will be treated as one official custodian for purposes of determining insurance coverage.

There are, however, special provisions for deposit of funds that by law or under a bond indenture are required to be paid to the holders of bonds issued by a governmental unit; e.g., bond interest and sinking funds. These provisions are included in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). For these types of funds, the beneficial interest of each bondholder would be aggregated with the bondholder's other accounts maintained in the same financial institution and be insured up to the legally-established maximum. There are also special provisions for funds deposited in trust accounts. When an insured bank acts as a fiduciary or cofiduciary, each separate trust estate is insured up to the legally-established maximum. This insurance is separate from and additional to that covering other deposits of the owners of the trust funds or the beneficiaries of the trust estates.

A "Confirmation of Deposit Collateral" form can be adapted to confirm the amounts and terms of federal depository insurance coverage (for example, FDIC) with the financial institution. In such a case, the following wording would be added as a separate paragraph before the last paragraph of the letter:

> In addition, please furnish a list of all federal depository insurance coverage as of [Date] and the accounts to which it applies.

If the depository institution is not federally insured, additional procedures will be necessary. In these circumstances, the confirmation request will have to be tailored specifically to the relevant state statutes or local ordinances. If depositories that are not federally insured are permissible, state statutes generally will specify the types and levels of collateral necessary to properly secure a public deposit.

Required Disclosures about Cash. GASBS No. 3, as amended by GASBS No. 40, *Deposit and Investment Risk Disclosures*, requires certain disclosures related to cash deposits with financial institutions as previously discussed.

SELF-STUDY QUIZ

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

11. The auditor uses relevant assertions in assessing the risks of material misstatement. Which of the following assertions is always relevant for cash?

    a. Existence and completeness.

    b. Valuation and classification.

    c. Rights or obligations.

12. Lu Newby, staff auditor, and Alfred Euclid, audit manager, have started another audit of a local city. Alfred has instructed Lu to confirm the cash balances. Which of the following is **not** a reason for confirming the cash balances?

    a. Confirmation of cash account balances will provide assurance about the reliability of the city's bank reconciliation.

    b. Confirmation of the balance of cash accounts provides audit evidence about the existence of the cash.

    c. Confirmation of the cash accounts provides audit evidence about cash obligations.

    d. Confirmation of cash account balances is required by GAAS and OMB Circular A-133.

13. In addition to confirming cash accounts, what is another substantive analytical audit procedure Lu can use to obtain audit evidence?

    a. Scanning bank reconciliations and records of cash receipts and disbursements.

    b. Reviewing loan, debt agreements and governing board minutes.

    c. Make inquiries of management concerning amounts designated for special purposes.

    d. Make predictions concerning the timing of cash transactions at the balance sheet date.

14. Lu Newby, staff auditor, has lost the electronic file of the audit program for cash for the City of Marine Creek. Listed below are some audit steps. Help Lu reconstruct her audit program by selecting the audit step that would be included in an audit of cash.

    a. Identify the material sources of revenue for the governmental entity.

    b. Confirm authorized check signers as required by local regulations.

    c. Confirm receivable with individual customers in accordance with the customer's billing cycle.

    d. Identify the budget items adopted by the governing body and test expenditures for compliance with the budget.

15. If a bank will not respond to paper confirmations of account balances, then electronic confirmations are considered a sufficient, valid response. Which below is **not** required for the auditor to be satisfied with the electronic response?

    a. The information is in direct response to the request.

    b. The electronic confirmation procedures are secure and properly controlled.

    c. A third party, the intended respondent is where the information was obtained.

    d. The bank balance is provided through an email by the government entity being audited.

SELF-STUDY ANSWERS

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

11. The auditor uses relevant assertions in assessing the risks of material misstatement. Which of the following assertions is always relevant for cash? **(Page 292)**

    a. Existence and completeness. [This answer is correct. When it comes to cash, the cash reflected in the financial statements must exist and all transactions must be recorded.]

    b. Valuation and classification. [This answer is incorrect. While proper classification of cash between restricted and unrestricted cash is relevant, the valuation of cash is only a relevant assertion when currency translation is involved.]

    c. Rights or obligations. [This answer is incorrect. While it is true that it is important that any restrictions on the availability of funds are properly disclosed, rights and obligations to cash may not always be relevant.]

12. Lu Newby, staff auditor, and Alfred Euclid, audit manager, have started another audit of a local city. Alfred has instructed Lu to confirm the cash balances. Which of the following is **not** a reason for confirming the cash balances? **(Page 293)**

    a. Confirmation of cash account balances will provide assurance about the reliability of the city's bank reconciliation. [This answer is incorrect. By confirming cash account balances, the auditors can rely on the city's bank reconciliation which provides audit evidence about other assertions relevant to cash.]

    b. Confirmation of the balance of cash accounts provides audit evidence about the existence of the cash. [This answer is incorrect. Confirming cash is the primary test of the existence assertion.]

    c. Confirmation of the cash accounts provides audit evidence about cash obligations. [This answer is incorrect. When confirming cash accounts, many times the confirmation includes any inquiry as to any restrictions on the cash account. By making this inquiry, the audit gathers audit evidence about the entity's right to the cash on deposit.]

    d. Confirmation of cash account balances is required by GAAS and OMB Circular A-133. [This answer is correct. Neither GAAS or OMB Circular A-133 require confirmation of cash account balances.]

13. In addition to confirming cash accounts, what is another substantive analytical audit procedure Lu can use to obtain audit evidence? **(Page 293)**

    a. Scanning bank reconciliations and records of cash receipts and disbursements. [This answer is correct. Scanning bank reconciliations for reasonableness and scanning cash receipts and disbursements for significant or unusual transactions at year end provide assurance about the various assertions relevant to cash.]

    b. Reviewing loan, debt agreements and governing board minutes. [This answer is incorrect. Although reviewing loan, debt agreements and governing board minutes are audit procedures applied to the cash accounts, they are not substantive analytical procedures.]

    c. Make inquiries of management concerning amounts designated for special purposes. [This answer is incorrect. Inquiries of management concerning amounts with special designation is an audit procedure for cash accounts, however, it is not a substantive analytical procedure.]

    d. Make predictions concerning the timing of cash transactions at the balance sheet date. [This answer is incorrect. The auditor would not be required to make predictions concerning the timing of cash transactions at the balance sheet date. The auditor is gathering evidence concerning the accuracy and existence of the cash accounts.]

14. Lu Newby, staff auditor, has lost the electronic file of the audit program for cash for the City of Marine Creek. Listed below are some audit steps. Help Lu reconstruct her audit program by selecting the audit step that would be included in an audit of cash. **(Page 296)**

    a. Identify the material sources of revenue for the governmental entity. [This answer is incorrect. Identifying the sources revenue is an audit step that would be performed when auditing receivables, not cash.]

    b. Confirm authorized check signers as required by local regulations. [This answer is correct. In addition to confirming balances, many times auditors confirm authorized signers in an audit of cash.]

    c. Confirm receivable with individual customers in accordance with the customer's billing cycle. [This answer is incorrect. Confirmation of receivables with individual customers is a step performed during the audit of billings and collections, not cash.]

    d. Identify the budget items adopted by the governing body and test expenditures for compliance with the budget. [This answer is incorrect. Comparing expenditures to budgeted items is an audit step performed during the audit of governmental fund expenditures, not cash.]

15. If a bank will not respond to paper confirmations of account balances, then electronic confirmations are considered a sufficient, valid response. Which below is **not** required for the auditor to be satisfied with the electronic response? **(Page 295**)

    a. The information is in direct response to the request. [This answer is incorrect. The information must be obtained through a direct response to the auditor for the confirmation to be valid.]

    b. The electronic confirmation procedures are secure and properly controlled. [This answer is incorrect. For the electronic confirmation to be considered sufficient and valid, the confirmation procedures are required to be secure and properly controlled.]

    c. A third party, the intended respondent is where the information was obtained. [This answer is incorrect. The information must be obtained directly from the intended respondent. In this example, the confirmation must be acquired from the bank.]

    d. The bank balance is provided through an email by the government entity being audited. [This answer is correct. For the electronic confirmation to be sufficient and valid, the confirmation must be supplied by the intended respondent. For bank confirmations, the intended respondent would be the financial institution.]

Investments

Relevant Assertions for Investments. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for investments are as follows:

- Existence or occurrence (E/O)—Reported investments represent positions that are on-hand, in-transit, or in the custody and safekeeping of others on behalf of the entity. Reported investment income represents amounts related to the period and pertains to the entity. Disclosed events and transactions have occurred and pertain to the entity.

- Completeness (C)—All investment-related income and expenditures/expenses related to the period and all investment balances have been reported. All required disclosures have been included in the financial statements.

- Rights or obligations (R/O)—Conditions and agreements that affect the entity's rights and obligations concerning investments have been properly reflected in the financial statements.

- Valuation or allocation (V)—Investments are included in the financial statements at appropriate amounts. Investments and investment-related transactions are disclosed at appropriate amounts.

- Accuracy or classification (A/CL)—Investments-related income and expenditures/expenses have been recorded at appropriate amounts and in the proper accounts. Investments have been included in the financial statements at appropriate amounts. Investments and investment-related transactions have been appropriately presented and described, and are disclosed fairly and at appropriate amounts in accordance with GAAP. Disclosures are clearly expressed.

- Cutoff (CO)—Amounts of investment-related income and expenditures/expenses have been recorded in the correct accounting period.

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

Substantive Audit Procedures for Investments. Substantive audit procedures for investments generally consist of a combination of inquiry and analytical procedures. If balances are material, substantive procedures may also include reviewing state and local laws and regulations; reviewing the governmental unit's investment policy, debt agreements, governing board minutes, and other supporting documents; vouching (for example, vouching activity during the year and comparing market values to quoted prices), confirmation; and inspection to obtain evidence about the following matters:

- Whether requirements of state and local laws and regulations, debt issuance documents, contribution and grant agreements, and other similar documents are appropriately considered in the governmental unit's written investment policy.

- Whether the investment policy and changes to it have been authorized by the governing body.

- Whether investments (during the year and at year end) are types authorized by the governmental unit's investment policy and legal and contractual provisions and, if applicable, actions taken to address any significant violations of those provisions during the period.

- Whether the governmental unit is in compliance (during the year and at year-end) with other compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

- Whether procedures for establishing and complying with investment risk policies are adequate.
- Whether policies for valuing investments are in conformity with GAAP and appropriately applied.
- Whether the governmental unit has considered the need to record impairment losses on investments reported using cost-based measures.
- Whether the allocation of internal investment pool balances and transactions is reasonable, accurate, in conformity with GAAP, and properly classified and disclosed in the financial statements.
- Whether investment disclosures are in conformity with GAAP and include all appropriate balances, including balances held by fiduciary funds.

Examples of inquiry and analytical procedures the auditor might perform at the account balance level for investments are as follows:

- Scan the activity during the year in the investment accounts, compare balances to those of the prior year or other auditor developed expectation and investigate unusual items.
- Consider the proper financial statements descriptions and classifications. Determine that investments and investment income are appropriately valued and properly classified.
- Evaluate the reasonableness of carrying amounts. Consider whether knowledge of the governmental unit and its activities indicates an impairment.
- Inquire about pledged investments, liens, or restrictions and relate to audit procedures in other areas (for example, debt confirmations and review of board minutes and debt agreements). Summarize information for financial statement disclosure.
- Inquire about whether the governmental unit has adopted an investment policy.
- Inquire about the types of investments authorized by legal and contractual provisions and the governmental unit's investment policy and determine whether there were any violations of those provisions during the period.
- Inquire about the governmental unit's use of derivatives securities lending, repurchase agreements, or reverse repurchase agreement, including the purpose for and management's controls over them.
- Discuss investment disclosures, including investment risk disclosures, with responsible officials; consider the reasonableness of the disclosures and their conformity with GAAP requirements.

Audit Program for Investments. A core audit program presents basic, extended, and additional substantive audit procedures for investments. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for investments that are normally adequate to respond to a set of underlying risk assessments (provided at the front of the audit program) considered typical of many governments.

In considering the audit procedures that should be applied to investments, the auditor should obtain an understanding of the nature of investments, the client's accounting policies for investments, frequency and amount of investment transactions, use of pooled investments, existence and composition of the investment committee, and legal, contractual, or policy restrictions on the types and amounts of investments.

Some governmental units have no significant investments other than certificates of deposit, which are actually deposits under GASB Statement No. 3 and should be audited simultaneously with cash. The audit program for investments should be used only when investments are significant. When investments are significant, a separate audit program is essential because of the additional complexities and requirements. The size and nature of investment activity will depend on whether operations generate excess cash and the period of cash availability.

When investments are material, they will normally be in marketable debt securities, rather than marketable equity securities.

Many governments use third-party service providers to make investment decisions, carry out investment transactions, provide custody of investment securities, or maintain investment accounting records. When this is the case, the auditor should consider the guidance of SAS No. 70, *Service Organizations* (AU 324). Also, governments occasionally use specialists to determine the fair value of investments and provide specialized reports for deposit and investment risk disclosures. Similarly, auditors may use specialists to evaluate those measurements and disclosures. When specialists are used, the auditor should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AU 336).

Auditing Considerations for Derivatives, Securities Lending Transactions, Reverse Repurchase Agreements, and SIVs

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU 332), provides specific guidance on planning and performing auditing procedures for financial statement assertions about derivatives, securities lending transactions, and reverse repurchase agreements. Among other things, AU 332:

- Indicates that the auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives, such as the ability to identify a derivative that is embedded in a contract or agreement.

- Identifies factors that affect inherent and control risk for assertions about derivatives and securities.

- Provides examples of audit procedures for derivatives, securities, and hedging transactions.

Structured Investment Vehicles. A structured investment vehicle (SIV) is a fund that borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. A SIV invests in a range of asset-backed securities, as well as some corporate bonds. A SIV buys new assets as old ones mature and generally exchanges investments without providing transparency to investors.

Some governmental units are invested in SIVs but lack sufficient understanding of the SIV's activities and risks. The SIV's solvency may be at risk if the value of the long-term security that it has bought falls below that of the short-term securities that it has sold. There is also potential liquidity risk—an SIV borrows on a short-term basis but invests long term. Thus, the payments it is required to make are due before cash is collected and available. Unless the governmental unit can refinance on a short-term basis at favorable rates, it may be forced to sell the asset into a depressed market. Recently, some SIVs have become victims of the extensive liquidity crunch in the markets.

The AICPA Audit Risk Alert, *State and Local Governmental Developments–2009*, indicates that auditors should obtain a thorough understanding of SIVs held by a governmental unit and place a particular audit focus on the risks associated with the investment (collateral), and give due consideration to involving specialists in the audit engagement to assist in the evaluation.

The auditor needs to assess whether all sophisticated investments (e.g., derivatives, securities lending transactions, repurchase/reverse repurchase agreements, and SIVs) have been identified by the client and properly reported in the financial statements. The auditor should not focus exclusively on evidence relating to cash receipts and disbursements. Because of the unique characteristics of these types of investments, it may be difficult to limit audit risk for assertions about completeness to an acceptable level without performing tests of controls. Procedures performed to test for completeness might include:

- Inquiry of management to determine if the entity has entered into any such contracts.

- Inspecting agreements to identify such investments and determine whether they are accounted for in accordance with GAAP and whether the governmental entity is in compliance with the terms of the agreements.

- Requesting information from counterparties to contracts.
- Confirming the existence of such investments with counterparties who are frequently used, but for whom accounting records indicate there are currently no such investments.
- Performing analytical procedures. For example, an analytical test of interest expense may identify the existence of an interest rate swap.
- Inspecting documentation for activity subsequent to year end that may indicate the existence of such investments at year end.
- Reading other information such as the minutes of governing body meetings for approval of such investments and transactions.

The auditor might consider confirming with the counterparty to the contract or with the executing broker significant terms and activity during the year. Also, the client's description of the use of such instruments might be validated by scanning activity and comparing it with the description.

Pooled Investments. Governmental units often pool investments of several funds for convenience, enhanced earnings opportunities, and better control over custody. However, pooling investments of some funds may be prohibited by law or contract.

Legal Restrictions. State statutes or local ordinances usually limit the types of investments permitted. Types and uses of investments may also be restricted by contractual or similar requirements. As explained in more detail later in this lesson, governments are required to disclose the types of investments authorized and any significant violations of investment restrictions. This means that, in a governmental engagement, it is important to determine that investments are of the types authorized by law, contract, and the investment policy of the governmental unit. Accordingly, the auditor might (a) inquire about whether the governmental unit has adopted an investment policy and the types of investments permitted by law, contract, or the investment policy; (b) review minutes of the investment committee (or similar committee) meetings; and (c) consider whether purchases or sales of investments during the period were authorized and in compliance with contractual and legal requirements as well as the entity's investment policy. It is also important to watch for unusual matters, such as indications of churning and investments in high-risk securities, especially including transactions involving derivative instruments, or securities lending, repurchase, or reverse repurchase transactions.

Some governmental units have made investments that violated various laws or were particularly complex and risky; e.g., derivatives, structured investment vehicles (SIVs), securities lending, repurchase, and reverse repurchase agreements. In some cases, a person making governmental investment decisions did not have sufficient skill and expertise to engage in particularly risky transactions, and unfortunate results were dramatically reported in the news media. Thus, it is particularly important that the auditor understand the nature, terms, relative risk, and details of each material investment and determine whether it is of a type allowed by law and investment policy.

Basic Audit Procedures for Investments. As is the case for cash, the detailed work for investments is very similar to the approach for a business enterprise of similar size. Routine procedures such as confirmation, physical inspection, and vouching are used. Naturally, when inspecting securities, it is important not to be left alone with the securities. Also, it may not be necessary to inspect all securities; e.g., individually significant items should be examined.

An interpretation of SAS No. 101 (AU 9328.01) provides guidance on auditing investments in securities held by a trust. The interpretation states that simply receiving a confirmation from the trustee, either in aggregate or on an investment-by-investment basis, does not constitute adequate audit evidence with respect to the requirements for auditing the fair value of the interest in the trust. In addition, receiving confirmation from the trustee for investments in aggregate does not constitute adequate evidence with respect to existence. However, receiving confirmation from the trustee on an investment-by-investment basis typically would be considered adequate evidence of existence. The interpretation further states that if the auditor is unable to audit the existence or measurement of interests in trusts at the financial statement date, the auditor should consider whether the scope limitation requires the auditor to either qualify the opinion or to disclaim an opinion.

An interpretation of SAS No. 92 (AU 9332.01) provides guidance on auditing investments in securities without a readily determinable fair value. In some circumstances, the third party will not provide management or the auditor detailed information about the basis and method for measuring the government's investment in the fund, nor will they provide information about the specific investments held by the fund. The interpretation indicates that when the auditor determines that audit procedures should include verifying the existence and testing the measurement of investments in securities, simply receiving a confirmation from a third party, either in the aggregate or on a security-by-security basis, does not constitute adequate evidence of valuation. Further, receiving confirmation from a third party for investments in the aggregate does not constitute adequate evidence of existence. However, receiving confirmation from a third party on a security-by-security basis typically would constitute adequate evidence of existence. The interpretation further states that if the auditor is unable to audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to either qualify the opinion or to disclaim an opinion.

GASB Statement No. 31. GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools* (GASB Cod. sec. I50), is the basic standard for valuation of governmental entity investments. The requirements of GASBS No. 31 provide consistency in reporting among governments and additional information to users of financial statements by establishing fair value standards for certain investments held by governmental entities and external investment pools. Fair value represents the current exchange value between two willing parties, other than a forced or liquidation sale. For governmental entities other than external investment pools, defined benefit pension plans, and OPEB plans, GASBS No. 31 requires investments in the following to be reported at fair value:

- external investment pools;
- open-end mutual funds;
- debt securities;
- equity securities, option contracts, stock warrants, and stock rights having readily determinable fair values; and
- participating interest-earning investment contracts that have a remaining maturity at the purchase date of more than one year [participating interest-earning investment contracts are those whose value is affected by market (interest rate) changes, such as a variable rate contracts].

GASBS No. 31, paragraph 5, exempts all of these assets from fair value reporting regardless of the type of entity reporting them:

- Investments in equity securities reported using the equity method (APBO No. 18, *The Equity Method of Accounting for Investments in Investments in Common Stock*).
- Investments in joint ventures or component units, as defined in GASBS No. 14, *The Financial Reporting Entity*.
- Securities or other investments that are not held for investment purposes either for the government itself or by the government in a fiduciary capacity. Examples include contractor performance deposits of debt securities and seized debt securities that the government holds as evidence or as a potential fine.

Under GASBS No. 31, governmental units other than external investment pools, defined benefit pension plans, and OPEB plans, may report certain money market securities at amortized cost if the remaining maturity was one year or less when purchased. Money market investments are defined as short-term, highly liquid debt instruments that include commercial paper, banker's acceptances, and U.S. Treasury and agency obligations. External investment pools may report short-term debt investments at amortized cost if the remaining maturity at the financial statement date is 90 days or less.

Participating interest-earning investment contracts with a remaining maturity of one year or less at time of purchase and whose fair value would not be significantly affected by the impairment of the credit standing of the issuer or by other factors, may also be reported at amortized cost. In addition, nonparticipating interest-earning investment contracts should be reported using a cost-based measure.

Governmental units sponsoring one or more external investment pools should account for the external portion of the pool in an *investment trust fund* (fiduciary fund category), using the economic resources measurement focus and the accrual basis of accounting. Statement No. 31 expands the disclosure requirements for governmental units other than pools and establishes minimum financial statements and disclosures in the sponsor's report for all external investment pools.

Investments of a Pension Fund. GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, requires that all plan investments, including debt and equity securities, real estate, and other investments except insurance contracts, be reported at their fair value at the reporting date. However, the fair value requirements of GASBS No. 31 apply to plan investments in the following:

- Securities subject to purchased put option contracts and written call option contracts.
- Open-end mutual funds.
- External investment pools.
- Interest-earning investment contracts.

Investments of a Defined Benefit OPEB Plan. GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, specifies accounting and financial reporting requirements that are similar to the requirements established by GASBS No. 25 for defined benefit pension plans. Under GASBS No. 43, all investments (including restricted stock and real estate investments) and valued at fair value except for unallocated insurance contracts, which are reported at contract value should be reported. Question 8.77.1 of the GASB *Comprehensive Implementation Guide—2009* reiterates that OPEB plan investments should be reported in the statement of plan net assets at their fair value, and requires fair value to be measured by the market price of investments (or estimated, if there is no active market). It further states that fair value should reflect brokerage commissions and other costs normally incurred in a sale, if determinable.

Real Estate Investments Held by Endowments. GASBS No. 52, *Land and Other Real Estate Held as Investments by Endowments*, requires governmental entities to report land and other real estate that make up the corpus of term and permanent endowments at fair value. Governments are also required to disclose the methods and significant assumptions used to estimate the fair values of these investments, if fair value is other than at quoted market prices. Although primarily applicable to colleges and universities, the standard also applies to permanent funds of other types of governmental entities.

Derivatives. Derivatives are complex financial instruments that governments commonly use as hedges against changes in interest rates on variable rate debt and may be used for other purposes, for example as hedges against changes in commodity prices such as fuel oil. The provisions of GASBS No. 31 are applicable to many types of derivatives. However, the applicability of GASBS No. 31 to derivatives should be evaluated based on the underlying investment type. Some derivatives, including certain hedging instruments, are not subject to GASBS No. 31 requirements. Accounting and financial reporting for those derivative instruments are established by GASBS No. 53, *Accounting and Financial Reporting for Derivative Instruments*. Because accounting and financial reporting for derivatives can be quite complex, an in-depth discussion is beyond the scope of this course. *PPC's Guide to Preparing Governmental Financial Statements under GASBS No. 34* provides comprehensive guidance on accounting and financial reporting for derivatives.

Definition of Derivative Instruments. The simplest way to think about derivatives is to think of financial instruments or contracts whose value derives from something else. For example, when a city issues $100 million of variable-rate demand bonds and at the same time enters into a pay-fixed, receive-variable interest rate swap with a notional or face amount of $100 million, the city has not issued a second $100 million of debt. Instead it has invested in a derivative, the fair value of which derives from or changes with the changes in fair value of $100 million of fixed rate debt. At its inception, the value (and cost) of the derivative is zero because the government does not owe the counterparty, nor does the counterparty owe the government.

The technical definition of a derivative is much more complicated. A derivative instrument is a financial instrument or other contract that has all of the following characteristics:

a. *Settlement factors*—one or more reference rates or underlyings and one or more notional or face amounts. (These determine the amount of the settlement, and, in some cases, whether or not a settlement is required.)

b. *Leverage*—requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that might have a similar response to changes in market factors.

c. *Net settlement*—terms require or permit net settlement, can readily be settled net by a means outside the contract, or provides for delivery of an asset which results in the recipient being in a position that is not substantially different from net settlement.

GASBS No. 53 Requirements. GASBS No. 53 applies to derivatives reported in proprietary funds, fiduciary funds, and government-wide statements in governmental or business-type activities. It does not affect accounting and reporting by governmental funds, except to the extent that it requires reporting reconciling items between governmental fund and government-wide financial statements.

Assets and liabilities are not reported if the broker agrees to maintain the risk of loss on the collateral. The broker's risk of loss might be indicated by the following factors:

- The agreement contains an explicit statement regarding the broker's risk of loss.

- The government is not able to change the nature of the collateral (that is, sell the securities for cash and use the cash to buy securities).

- The government would not be liable to pay back the collateral if it lost 100 percent of its value.

Collateral that is reported as assets and consists of either (a) investments or (b) investments purchased with cash collateral should be reported in accordance with GASBS No. 31, generally at fair value. The AICPA Audit Risk Alert, *State and Local Government Developments—2009*, indicates that it is important for auditors to thoroughly understand the valuation methodologies applied to these investments, the underlying risks involved with each investment type, and the likelihood that the value of the investments will be impaired.

Repurchase and Reverse Repurchase Agreements. Even though a governmental unit is prohibited from making many types of investments, it may engage in repurchase or reverse repurchase agreements because the federal government obligations underlying these types of security agreements are an acceptable form of investment. Thus, the auditor should inquire specifically about the nature of investment transactions in federal government obligations and the business strategy of such transactions. Inquiry is necessary because the transactions may appear to be separate sales and purchases of federal obligations in the accounting records and there may be no written agreement.

Repurchase and reverse repurchase agreements involve several risks not present in separate sales and purchase transactions, and the auditor needs to be concerned about whether these risks have been identified and adequately considered. The auditor needs to assess any unusual aspects of the investment, such as collateral held by third parties, and consider whether confirmation of the existence and value of the collateral is adequate or whether additional procedures are necessary.

Auditing Considerations. The audit program for investments should be used when investments are significant. If it is necessary to audit investments separately from cash, auditors should be aware that most governmental units primarily invest in marketable debt securities rather than in marketable equity securities.

Securities Lending Transactions. In a securities lending transaction, a governmental unit (lender) transfers its securities to a broker-dealer (borrower) for collateral and agrees to return the collateral for the same securities in the future. If the collateral is cash, the government invests the cash for the purpose of earning an investment return that will exceed the rebate to be paid to the borrower. If the collateral is securities or letters of credit, the government is paid a fee for the securities loan.

According to GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, the governmental unit should report lent securities as assets in its balance sheet. Cash received as collateral (and any resulting investments) should be reported as an asset and liability. Securities received as collateral should only be reported as assets and liabilities if the government has assumed the risk of loss. Risk of loss on the collateral is determined by analyzing the government's ability to pledge or sell them without borrower default. A governmental unit should not report assets and liabilities for collateral in the form of letters of credit or securities that cannot be sold or pledged.

Required Disclosures about Investments. Several different GASB pronouncements establish disclosure requirements for investments.

<u>GASBS No. 31 Disclosures.</u> Paragraph 15 of GASBS No. 31 requires the following disclosures about investments, including land and other real estate held as investments by permanent and term endowments and permanent funds, in the notes to the financial statements:

a. The methods and significant assumptions used to estimate the fair value of investments, if that fair value is based on other than quoted market prices.

b. The policy for determining which investments, if any, are reported at amortized cost.

c. For investments in external investment pools that are not SEC-registered, a brief description of any regulatory oversight for the pool and whether the fair value of the position in the pool is the same as the value of pool shares.

d. Any involuntary participation in an external investment pool.

e. If an entity cannot obtain information from a pool sponsor to allow it to determine the fair value of its investment in the pool, the methods used and significant assumptions made in estimating that fair value and the reasons for having had to make such an estimate.

f. Any income from investments associated with one fund that is assigned to another fund.

<u>GASBS No. 3 Disclosures for Investments.</u> GASBS No. 3, as amended by GASBS No. 40, requires certain disclosures related to investments, including the types of investments authorized by legal or contractual provisions, any significant violations of those provisions during the year, types of investments held at year end, custodial credit risk, concentrations of credit risk, interest rate risk, and foreign currency risk.

<u>Disclosures about Securities Lending Transactions.</u> GASBS No. 28 requires certain disclosures related to securities lending transactions, including the source of legal authorization for participation, a description of the transactions, and several risk disclosures.

<u>Disclosures about Real Estate Investments Held by Endowments.</u> GASBS No. 52 expands the disclosure requirements of GASBS No. 31 to land and other investments held by endowments. GASBS No. 52 requires disclosure of the methods and significant assumptions used to estimate the fair values of those investments, if fair value is other than at quoted market prices. Although primarily applicable to colleges and universities, the standard also applies to permanent funds of other types of governmental entities.

<u>Disclosures by Pension and OPEB Plans.</u> GASBS No. 25, as amended by GASBS Nos. 40, 43, and 50, *Pension Disclosures*, requires certain disclosures by defined benefit and defined contribution pension or OPEB plans with respect to investments they hold, including the method and significant assumptions used to estimate the fair value of their investments if fair value is based on something other than quoted market prices. GASBS No. 43, *Financial*

Reporting for Postemployment Benefit Plans Other Than Pension Plans, requires the same disclosures by OPEB plans.

Disclosures about Derivatives—GASBS No. 53. GASBS No. 53 requires certain disclosures about derivatives that, vary depending on whether the derivatives are considered to be investment instruments, hedging instruments, hybrid instruments, or synthetic guaranteed investment contracts (SGIC).

SELF-STUDY QUIZ

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

16. Listed below are several audit assertions; which one does **not** pertain to the audit of investments for a local government?

    a. Existence or occurrence—Investment transactions occurred and relate to the entity.

    b. Completeness—All investments-related income and expenditures expenses related to the period and all investment balances have been reported.

    c. Cutoff—Investment-related income and expenditures/expenses have been recorded in the correct accounting period.

    d. Cutoff—Cash balances reflect a proper cutoff of receipts and disbursements.

17. Listed below are several substantive audit procedures. Which one pertains to investments?

    a. Make inquiries concerning the types of deposits authorized by legal and contractual provisions and any violations of those provisions during the period.

    b. Discuss investment disclosures with responsible officials; consider their conformity with GAAP requirements.

    c. Test to determine if separate bank accounts are maintained for individual funds that are required by law.

    d. Test to determine if any portion of account balances have a custodial credit risk.

18. Lu Newby, staff auditor, has just completed the field work for Tiny Town, which had no investments other than certificates of deposit. During the field work for Tiny Town, Lu included the substantive testing of the certificates of deposit with the testing performed on the cash accounts. Lu is planning to use this same audit approach on the audit of the City of Marine Creek which has significant investments in marketable debt securities. What audit approach should Lu use and what is the best reason for the decision?

    a. Lu should use a separate audit program for the investments because the investments are significant.

    b. Lu is correct in using the same audit program for cash as for investments because both cash and marketable securities have values that can be easily established.

    c. Lu should use a separate audit program for investments because it will make the audit more efficient.

    d. Lu should use the same audit program for both cash and investments because it is not that much different to verify interest income on a CD as it is for a marketable debt security.

19. Lu Newby, staff auditor, is working on auditing the investments of the City of Marine Creek. Lu has encountered some securities without a readily determinable fair value. What are the implications of this type of asset on the audit?

    a. Lu can confirm the existence and measurement of the securities by simply confirming with a third party.

    b. Lu can confirm the measurement of the securities by confirming with a third party; however, Lu will be unable to confirm the existence of the securities with a third party.

    c. Lu may need to rely on a third-party and may be unable to audit the existence or measurement of the security interest; therefore, Lu may need to determine if this is a scope limitation which requires either a qualified opinion or a disclaimer opinion.

20. Which of the following accurately defines structured investment vehicles for a governmental unit?

    a. The governmental unit establishes an account with a brokerage institution and purchases securities with borrowed funds.

    b. The governmental unit establishes an account with a brokerage institution and sells securities it promises to buy at a later date in anticipation that the purchase price will go down.

    c. The governmental unit issues short-term securities at a low interest to borrow money and then lends the money by purchasing long-term securities at higher interest.

    d. The governmental unit acts as a "seller-borrower" and transfers federal obligations to a financial institution in exchange for cash and promises to repay the cash plus interest in return for the same securities.

21. GASB Statement No. 31 establishes fair value standards for certain investments held by governmental units. All of the following types of investments are included under Statement No. 31 **except**:

    a. External investment pools.

    b. Open-end mutual funds.

    c. Equity securities.

    d. Certificates of deposit.

22. Permanent endowments and real estate held by endowments of a governmental entity are required to be accounted for at fair value. In addition, it is mandatory that the entity reveal the method used to determine the fair value of the investments.

    a. True.

    b. False.

23. Alfred Euclid wants to determine how familiar the staff auditor, Lu Newby, is with the required disclosures under GASBS No. 31 and gives several choices as shown below. Which of the choices should Lu select as required by GASBS No. 31?

    i. The methods and significant assumptions used to estimate the fair value of investments.

    ii. The types of investments authorized by legal provisions.

    iii. The source of legal authorization for participation in securities lending transactions.

    iv. Derivatives not reported at fair value.

    a. iv only.

    b. i only.

    c. i and ii only.

    d. iii and iv only.

SELF-STUDY ANSWERS

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

16. Listed below are several audit assertions; which one does **not** pertain to the audit of investments and derivatives for a local government? **(Page 292)**

    a. Existence or occurrence—Investment and derivative transactions occurred and relate to the entity. [This answer is incorrect. The auditor will include the assertion of the existence of investments and derivatives in an audit of a local government.]

    b. Completeness—All investment-related income and expenditures/expenses related to the period and all investment balances have been reported. [This answer is incorrect. The auditor will include the assertion that the financial statements reflect a complete listing of all investments or derivatives. Any investment owned by the local government and omitted from the listing will represent an understatement of assets.]

    c. Cutoff—Investment-related income and expenditures expenses have been recorded in the correct accounting period. [This answer is incorrect. The auditor will include the assertion that the financial statements reflect a complete listing of investments and derivatives recorded in the proper accounting period along with any gains or losses or changes in valuation in an audit of a local government.]

    d. Cutoff—Cash balances reflect a proper cutoff of receipts and disbursements. [This answer is correct. Although an auditor will have an assertion with regard to investments and derivatives properly reflected in the financial statements of a local government; this answer choice actually pertains to the cutoff assertion the auditor makes with regard to cash.]

17. Listed below are several substantive audit procedures. Which one pertains to investments and derivatives? **(Page 306)**

    a. Make inquiries concerning the types of deposits authorized by legal and contractual provisions and any violations of those provisions during the period. [This answer is incorrect. This answer choice describes a substantive audit procedure for bank accounts.]

    b. Discuss investment disclosures with responsible officials; consider their conformity with GAAP requirements. [This answer is correct. This answer choice describes an audit procedure related to investments and derivatives. Another one would be to determine that unrealized gains and losses are valued appropriately and classified properly.]

    c. Test to determine if separate bank accounts are maintained for individual funds that are required by law. [This answer is incorrect. Although separate investment accounts may be required by law, this answer choice describes the substantive audit test for cash accounts.]

    d. Test to determine if any portion of account balances have a collateral credit risk. [This answer is incorrect. One of the unique features of governmental audits is the requirement to collateralize deposit accounts which may exceed depository insurance. This answer choice relates to the substantive audit procedures performed to test for adequate collateral.]

18. Lu Newby, staff auditor, has just completed the field work for Tiny Town, which had no investments other than certificates of deposit. During the field work for Tiny Town, Lu included the substantive testing of the certificates of deposit with the testing performed on the cash accounts. Lu is planning to use this same audit approach on the audit of the City of Marine Creek which has significant investments in marketable debt securities. What audit approach should Lu use and what is the best reason for the decision? **(Page 304)**

    a. Lu should use a separate audit program for the investments because the investments are significant. [This answer is correct. When investments are significant, a separate audit program is necessary because of the complexities such as investments held in trust, and debt securities purchased at a discount which must be amortized, etc.]

    b. Lu is correct in using the same audit program for cash as for investments because both cash and marketable securities have values that can be easily established. [This answer is incorrect. While establishing the proper valuation of cash and securities may be easily done, there are other requirements for investments which must be substantiated during an audit such as whether or not the investments conform to an investment policy established by the governmental unit.]

    c. Lu should use a separate audit program for investments because it will make the audit more efficient. [This answer is incorrect. Using separate audit programs for cash and investments will eliminate the risk of missing the testing of features unique to marketable debt such as the proper classification in the financial statements between current and non-current assets thus making the audit more efficient. However, an efficient audit is not the best reason for using separate audit programs for cash and investments.]

    d. Lu should use the same audit program for both cash and investments because it is not that much different to verify interest income on a CD as it is for a marketable debt security. [This answer is incorrect. The substantive procedures for verifying the receipt of interest income from a bond or a CD may not be much different. However, there are other significant difference between the investment in a CD and the investment in a marketable debt security which must be included in a specific audit program for investments.]

19. Lu Newby, staff auditor, is working on auditing the investments of the City of Marine Creek. Lu has encountered some securities without a readily determinable fair value. What are the implications of this type of asset on the audit? **(Page 307)**

    a. Lu can confirm the existence and measurement of the securities by simply confirming with a third party. [This answer is incorrect. An interpretation of SAS No. 92 specifically indicates that confirmation of the existence and measurement of securities in the aggregate with a third party will not be considered adequate audit evidence.]

    b. Lu can confirm the measurement of the securities by confirming with a third party; however, Lu will be unable to confirm the existence of the securities with a third party. [This answer is incorrect. Lu may be able to confirm the existence on a security-by-security basis with a third party, however, an interpretation of SAS No. 92 indicates confirming the valuation of assets on a security-by-security basis does not constitute adequate evidence for valuation.]

    c. Lu may need to rely on a third-party and may be unable to audit the existence or measurement of the security interest; therefore, Lu may need to determine if this is a scope limitation which requires either a qualified opinion or a disclaimer opinion. [This answer is correct. An interpretation to SAS No. 92 indicates that an auditor's inability to audit the existence of measurement of investments in securities may in fact be a scope limitation which will affect the auditor's opinion.]

20. Which of the following accurately defines structured investment vehicles for a governmental unit? **(Page 308)**

    a. The governmental unit establishes an account with a brokerage institution and purchases securities with borrowed funds. [This answer is incorrect. This answer choice defines purchasing securities using a margin account.]

    b. The governmental unit establishes an account with a brokerage institution and sells securities it promises to buy at a later date in anticipation that the purchase price will go down. [This answer is incorrect. This answer choice reflects securities put transaction.]

    c. The governmental unit issues short-term securities at a low interest to borrow money and then lends the money by purchasing long-term securities at higher interest. [This answer is correct. This answer choice defines the basic repurchase agreement.]

    d. The governmental unit acts as a "seller-borrower" and transfers federal obligations to a financial institution in exchange for cash and promises to repay the cash plus interest in return for the same securities. [This answer is incorrect. This answer choice reflects the definition of a reverse repurchase agreement.]

21. GASB Statement No. 31 establishes fair value standards for certain investments held by governmental units. All of the following types of investments are included under Statement No. 31 **except**: **(Page 307)**

    a. External investment pools. [This answer is incorrect. External investment pools are covered under Statement No. 31.]

    b. Open-end mutual funds. [This answer is incorrect. Statement No. 31 establishes fair value standards for open-end mutual funds.]

    c. Equity securities. [This answer is incorrect. Equity securities as well as debt securities are both covered by GASB Statement No. 31.]

    d. Certificates of deposit. [This answer is correct. CDs are really cash accounts rather than investment accounts. The principal invested does not have a fluctuating market value.]

22. Permanent endowments and real estate held by endowments of a governmental entity are required to be accounted for at fair value. In addition, it is mandatory that the entity reveal the method used to determine the fair value of the investments. **(Page 309)**

    a. True. [This answer is correct. Government entities are required to report endowments at fair value and disclose how the fair value was estimated.]

    b. False. [This is answer incorrect. GASBS No. 52 requires endowments of government entities to be reported at fair value and that the assumptions used to achieve the fair value be disclosed.]

23. Alfred Euclid wants to determine how familiar the staff auditor, Lu Newby, is with the required disclosures under GASBS No. 31 and gives several choices as shown below. Which of the choices should Lu select as required by GASBS No. 31? **(Page 310)**

    i. The methods and significant assumptions used to estimate the fair value of investments.

    ii. The types of investments authorized by legal provisions.

    iii. The source of legal authorization for participation in securities lending transactions.

    iv. Derivatives not reported at fair value.

    a. iv only. [This answer is incorrect. GASB Technical Bulletin No. 2003-1 requires certain disclosures about derivatives not reported at fair value.]

    b. i only. [This answer is correct. This answer choice describes one of six disclosures required by GASBS No. 31.]

    c. i and ii only. [This answer is incorrect. GASBS No. 31 requires disclosure of the types of investments authorized by legal provisions.]

    d. iii and iv only. [This answer is incorrect. Securities lending transactions are discussed by GASBS No. 28 and GASBTB No. 2003-1 discusses derivatives not reported at fair value.]

REVENUES AND EXPENDITURES

This discussion emphasizes those aspects of audit programs for revenues and expenditures that are unusual or unique to governmental engagements.

Relevant Assertions for Revenues and Receivables

Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for revenues and receivables are as follows:

- Existence or occurrence (E/O)—Reported revenues represent amounts relating to the entity. Reported receivables represent amounts uncollected as of the end of the period. Reported deferred revenues represent amounts received or receivable that have not met the criteria for revenue recognition. Disclosed revenue, receivables, and deferred and unearned revenue events and transactions have occurred and pertain to the entity.

- Completeness (C)—All revenues related to the period and all receivables, deferred revenues, and unearned revenues as of the end of the period have been reported. All required disclosures have been included in the financial statements.

- Rights or obligations (R/O)—Conditions and agreements that affect the entity's receivables, deferred revenues, and unearned revenues as of the end of the period have been properly reflected in the financial statements.

- Valuation or allocation (V)—Receivables, deferred revenues, and unearned revenues are reported at the proper amounts. Information pertaining to revenues, receivables, deferred revenues, and unearned revenues is disclosed at appropriate amounts.

- Accuracy or classification (A/CL)—Amounts and other data relating to revenue transactions and events have been recorded appropriately and in the proper accounts. The financial statements properly classify, describe, and disclose revenues, receivables, deferred revenues, and unearned revenues, including classification in the proper fund and activity. Financial and other information relating to revenues, receivables, deferred revenues, and unearned revenues is appropriately presented and described and disclosed fairly and at appropriate amounts in accordance with GAAP. Disclosures are clearly expressed.

- Cutoff (CO)—Revenue transactions and events have been recorded in the correct accounting period.

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

Substantive Audit Procedures for Receivables. The auditor obtains audit evidence for revenues and receivables primarily through reviewing statutes and regulations; reviewing governing board minutes, and other supporting documents; and through the use of confirmation, inquiry, and analytical procedures to obtain evidence about the following matters:

- Whether the governmental unit is in compliance (during the year and at year-end) with compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

- Whether tax, fee, and service rates are billed consistently and whether rate changes are incorporated into the billing system on a timely basis.

- Whether tax, fee, and service rates are in compliance with legal and regulatory requirements or limitations.
- Whether abatements, exonerations, refunds, and similar matters have been properly approved.
- Whether tax exemptions of properties and organizations are proper.
- Whether taxpayer-assessed tax returns were calculated in accordance with laws and regulations.
- Whether revenue recognition and classification principles are in conformity with GAAP and are consistently applied.
- Whether the allowances for uncollectible revenues are adequate and whether the governmental unit filed liens or took other legally-required steps to ensure collectibility.
- Whether amounts reported for probable revenue-related refunds, such as for taxes, are adequate.
- Whether revenues are properly recorded for amounts collected by another entity.
- Whether amounts collected for other governments are properly accounted for and segregated.
- Whether revenue and receivable disclosures are in conformity with GAAP.

Substantive Audit Procedures for Receivables. Examples of substantive procedures at the account balance level for receivables are as follows:

- Compare the balance in receivables with the balance for prior years or other auditor-developed expectations and investigate unusual variations.
- Compute the ratio of the receivables balance to related revenue for the current and prior years and investigate any unexpected results.
- Review a reconciliation of the aged receivables balance to the general ledger account balance, and document an explanation for any unusual reconciling items. Consider whether it is necessary to review documentation supporting the reconciling items and explanations.
- Scan the trial balance for unusual items, such as large credit balances, unusual names, receivables from known related parties and propose reclassifications, if necessary.
- Confirm selected receivables.
- Test the adequacy of the allowance for uncollectible accounts by inquiring about the client's process for estimating the allowance, performing analytical procedures, and investigating any unusual results.
- Compare revenues for the last month of the year to the rest of the year and to the first month after year end. Compare credit memos for the last few months of the year to the first few months after year end to test cutoff.

Other procedures in the cash, debt, and related-party areas of the audit also may provide evidence related to receivables. Debt agreements, other confirmations, and the review of minutes can produce information about pledged, discounted, assigned, or sold receivables. In addition, informing the audit team of known related parties (for example, during the engagement team discussion) will help to make each auditor more alert for significant related-party receivables.

Substantive Audit Procedures for Revenues. Because of the interrelationship of receivables and revenues, substantive tests of revenues (generally analytical procedures) provide audit evidence for assertions related to revenues and may also provide additional audit evidence for assertions related to receivables. Examples of substantive analytical procedures for revenues are as follows:

- Inquire of responsible officials about how the government raises revenue and identify the major revenue sources. Obtain an understanding of the governmental unit's revenue recognition policies and determine that they are in accordance with GAAP. Inquire of management about, and evaluate, changes in revenue recognition policies and significant, unusual, and complex revenue transactions occurring at or near year end.

- Scan a schedule summarizing revenues by fund and type of revenue for the year and perform analytical procedures such as comparing amounts to those of prior periods and to the adopted budget or other auditor-developed expectations. Investigate any unexpected results.

- Consider the allocation of revenues to the government's funds in accordance with the intent of the governing body and the requirements of laws, regulations, and contract and grant agreements.

- Scan the accounting records and review supporting documentation for large or unusual transactions near year end.

- Test compliance with legal and contractual provisions that could have a direct and material effect on the determination of financial statement amounts.

- Test tax, fee, and service rates for compliance with legal and regulatory requirements or limitations.

In addition, SAS No. 99 creates a rebuttable presumption that there is a risk of material misstatement of revenue due to fraud (AU 316.41). If the auditor does not overcome that presumption, SAS No. 99 requires the auditor to perform analytical procedures relating to revenue to respond to that risk. The objective of the analytical procedures is to identify unusual or unexpected relationships that might indicate a revenue recognition fraud.

Audit Program for Revenues, Receivables, and Receipts—Governmental Funds. A core audit program presents basic, extended, and additional substantive audit procedures for revenues, receivables, and receipts of governmental funds. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for revenues, receivables, and receipts of governmental funds that are normally adequate to respond to a set of underlying risk assessments (provided at the front of the audit program) considered typical of many governments.

Effective Analytical Procedures. Effective analytical procedures for revenues of governmental funds can often be designed based on reliable data from outside the governmental unit's accounting system. Property tax provides an excellent example. In the property tax area, analytical procedures are very effective because relatively accurate predictive tests can be made. Property taxes should be relatively easy to estimate because the factors involved (i.e., assessed valuation and tax rate) are usually known. Fluctuations from period to period should be small or explainable based on known changes; e.g., 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; e.g., 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; compare it to the recorded property tax revenue; and consider whether the tax rates are in compliance with state-imposed limitations, if any. Any differences between the total computed tax revenue and recorded revenue should be very small. If there is no significant difference between the computed and recorded property tax revenue, the audit objectives for property tax revenue have been achieved.

In many instances, maintenance of the tax roll, determination of the assessed valuation, and tax billings and collections are the responsibility of another governmental unit (e.g., a county appraiser). The relationship between these units may be dictated by law or be the subject of a local agreement. In some instances, the other governmental unit may be acting as a service organization. Determination of whether the other governmental unit is acting as a service organization and the audit procedures that should be performed, including the procedures required by SAS No. 70 (AU 324), *Service Organizations*, is a matter of professional judgment.

Governmental Fund Receivables and Confirmation. SAS No. 67 (AU 330.34) established guidelines for the confirmation process in audits performed in accordance with generally accepted auditing standards. There is a presumption that confirmation requests for accounts receivable will be made in a GAAS audit unless one of the following conditions is true:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective.
- The auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the related financial statement assertions. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level.

When confirmations are not requested, documentation should be made of how the auditor overcame this presumption. For example, the authors feel that confirmation of property taxes receivable is not a required procedure under SAS No. 67 because property taxes receivable do not fit the definition of accounts receivable given at AU 330.34:

- A claim against a customer that has arisen from the sale of goods or services in the normal course of business.
- A financial institution's loans.

However, if confirmation of property taxes receivable was required by SAS No. 67, it would normally be an *ineffective* audit procedure. AU 330.34 states that an audit procedure would be ineffective if, in prior years, the response rate to properly designed confirmation requests was inadequate or if responses are known or expected to be unreliable. Substantial portions of property taxes are paid for the property owner by mortgage companies from escrow accounts. Experience shows that mortgage companies rarely return confirmation requests due to the large number of requests received by them each year. In addition, confirmation requests for property taxes sent to individuals historically have a low response rate. Therefore, if the auditor decides not to confirm property taxes receivable, the reason should be documented in the workpapers.

In contrast, confirmation is often a very useful procedure for taxes collected by other governmental units; e.g., sales taxes collected by the state or county and certain franchise taxes. Normally, the auditor should confirm with other governmental units the amounts of taxes collected for and transmitted to the governmental unit being audited, as well as amounts collected still to be remitted. Thus, the confirmation substantiates both the revenue and the receivable.

Electronic Confirmations. An Auditing Interpretation at AU 9330.01 states that email confirmations sent or received directly by the auditor may be considered reliable audit evidence if the auditor is satisfied (a) that the electronic confirmation process is secure and properly controlled, (b) the confirmation is directly in response to a request, and (c) is from a third party who is the intended respondent.

When using electronic confirmations, the auditor should consider the following risks to the reliability of such information:

- The response might not be from an authentic source.
- The respondent might not be knowledgeable about the information.
- The integrity of the transmission might be compromised.

Accounting Considerations. The basis of revenue recognition for governmental funds is different than for business enterprises. Governments should present governmental funds on the modified accrual basis of accounting in the governmental funds financial statements and on the accrual basis of accounting in the government-wide financial statements. Instead of recognizing revenue when it is earned, governmental fund revenues are accrued when they are measurable and available. The concept of earning revenue is less relevant in the governmental environment than in the business sector because many tax revenues are obtained through levies rather than through the sale of goods or services. "Available" means that the revenues will be collected during the year or soon enough thereafter to pay liabilities arising from operations during the year just ended. For property taxes, NCGA No. 3 defined this available period to include taxes that were due and collected within 60 days after the end of the entity's fiscal year. GASB Interpretation 5, *Property Tax Revenue Recognition in Governmental Funds, an interpretation of NCGA Statement 1 and an amendment of NCGA Interpretation 3* deletes the due date criteria when recognizing property tax revenues. Property tax receipts collected during the 60 day period can be recorded as revenue regardless of their due date.

Sales and use taxes are classified as derived tax revenues under GASBS No. 33. They should be recognized as revenue when the underlying exchange takes place and the revenues are measurable and available. Revenues should be recognized net of estimated refunds and estimated uncollectible amounts.

Nonexchange Transactions. GASBS No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, establishes general standards for the timing of recognition of nonexchange transactions, based on the principal characteristics of the following classes of nonexchange transactions:

- *Derived Tax Revenues.* Assets should be recognized upon the earlier of the underlying exchange transaction occurring or the resources being received. Revenues should be recognized when the underlying exchange transaction occurs, with earlier receipts reported as deferred revenues. Examples include personal and corporate income taxes (based on earnings) and sales and use taxes (based on retail sales), including motor fuel taxes and hotel/motel taxes.

- *Imposed Nonexchange Transactions.* Assets should be recognized upon the earlier of the formation of an enforceable legal claim or the resources being received. Revenues should be recognized when use of the resources is required or first permitted by time requirements. Resources received before the time requirements are met should be reported as deferred revenues. Examples include property taxes, fines, penalties, and property forfeitures, including seizures and escheat property.

- *Government-mandated and Voluntary Nonexchange Transactions.* Assets (recipients) and liabilities (providers) should be recognized upon the earlier of meeting all eligibility requirements for the resources being received. Revenues (recipients) and expenses (providers) should be recognized when all eligibility requirements have been met, with advance receipts reported as deferred revenues or advances. Permanent or term endowments should be recognized when received/paid with a corresponding restriction of net assets. Examples include state mandated road improvements, certain grants, entitlements, and donations.

GASBS No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, amends GASBS No. 33, paragraph 28, and requires both providers and recipients of shared derived tax or imposed nonexchange revenues to comply with the accounting requirements for voluntary or government mandated nonexchange transactions. In other words, both the provider and recipient record revenues and expenses or expenditures when all eligibility requirements have been met.

Interfund Transfers. GASBS No. 34, paragraph 112, defines interfund transfers as "flows of assets (such as cash or goods) without equivalent flows of assets in return and without a requirement for repayment." In governmental funds, transfers should be reported as other financing uses in the funds making transfers and as other financing sources in the funds receiving transfers. In proprietary funds, transfers should be reported after nonoperating revenues and expenses.

Interfund receivables, payables, and loans should be separately disclosed in each fund's balance sheet; they should not be netted. The auditor should determine any limitations on the governmental unit's ability to make interfund transactions (e.g., legal authority of a fund to transfer revenue, statutory authorization for an interfund loan, budgetary provision, etc.), and the auditor should determine the level of authority required to approve interfund transactions. Audit procedures for interfund transactions include reconciliation of interfund balances and consideration of their proper approval, collectibility, and classification.

Sales and Pledges of Receivables and Future Revenues. Governments sometimes sell or pledge a portion of their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments—generally, a single lump sum. GASBS No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, provides guidance to governments that sell or pledge either receivables or future revenues. GASBS No. 48 also provides guidance when those transactions take place between the primary government and a separate legal entity that is required by GASBS No. 14 to be reported as a blended or discretely presented component unit. However, the scope of GASBS No. 48 *excludes* the relatively common situation in which governments pledge their "full faith and credit" as security for their own debt, such as for general obligation bonds or revenue bonds, or for the debt of a component unit.

Reporting under GASBS No. 48 depends on whether the transaction qualifies as a *sale* or a *collateralized borrowing*. GASBS No. 48 provides two distinct sets of criteria for making this assessment—one for transactions involving receivables and one for transactions involving future revenues. Unless these criteria are met, the transactions are reported as collateralized borrowings. Sales of receivables require immediate revenue recognition; borrowings defer revenue recognition. Proceeds from sales of future revenues generally are deferred and recognized over the duration of the agreement.

<u>Required Disclosures.</u> If a government sells or pledges future revenues to directly collateralize or secure its debt or indirectly collateralize or secure debt of a component unit, certain disclosures are required. For each period in which debt secured by a pledge of future revenues is outstanding, GASBS No. 48, paragraph 21 requires governments to disclose the following:

a. The specific revenue pledged and the approximate amount of the pledge. The approximate amount generally is equal to remaining principal and interest payments on the debt.

b. Identity of and the general purpose for which the secured debt was issued.

c. The period during which the pledged revenue will not be available for other purposes.

d. The ratio of the pledged amount to the total for that specific revenue, if estimable.

e. A comparison of pledged revenues recognized during the period to the principal and interest payments made during the period for the debt directly or indirectly secured by pledged revenues. Pledged revenues may be presented net of specified operating expenses, as provided in the pledge agreement. (The amounts should not be netted in the financial statements.)

In the year that a government sells future revenue streams GASBS No. 48, paragraph 22, requires these disclosures about specific revenues sold:

- Identity of the specific future revenue sold, including the approximate amount, and the significant assumptions used to determine that amount.

- The period to which the sale applies.

- The ratio of the sold amount to the total for that specific revenue, if estimable.

- A comparison of the amount received and the present value of the future revenues sold, and the significant assumptions used to determine that present value.

Audit Program for Service Revenue and Receivables—Proprietary Fund Types. A core audit program presents basic, extended, and additional substantive audit procedures for service revenue and receivables of proprietary funds. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for service revenue and receivables of proprietary funds that are normally adequate to respond to a set of underlying risk assessments (provided at the front of the audit program) considered typical of many governments.

The Need for Confirmation. Confirmation of receivables with individual customers has been considered a generally accepted auditing procedure in the audit of service funds of a governmental unit. Under SAS No. 67 (AU 330.34), there is a presumption that the auditor will request the confirmation of such receivables. An efficient audit procedure is to confirm only individually significant items and to use a test of subsequent collections as an alternative procedure for the remaining balance. An individually significant item can be any amount up to tolerable misstatement.

Service fund billed receivables are often substantially collected shortly after the end of the accounting period. Thus, the test of subsequent collections is a good procedure to apply to the remaining balance after confirming individually significant items. The auditor should prepare a schedule of cash collections by month and calculate the collections for the financial statement period's billings on a dollar amount and percentage basis. The collections for the fiscal period, plus the collections for the first month of the next period, less the collections for the first month of the current period, equals the collections for the current period's billings.

In addition to this procedure, the auditor should consider surrounding circumstances and the results of other analytical procedures. The auditor should consider whether there have been any significant changes in the service fund's billing procedures and customer mix. Also, the auditor should consider whether the relationship of unbilled receivables to the prior period's unbilled receivables and the current period's billed receivables has remained substantially unchanged. The auditor should also consider the results of related analytical procedures, such as comparison of the service fund's gross profit percentage in the current and prior periods.

Confirmation and Cycle Billing. In the audit of service funds of a governmental unit, the approach to confirmation of receivables with individual customers has to be adapted for cycle billing. Usually, cycle billing is used to spread the work involved in measuring customer usage, billing, and collection. The number of billing dates used can vary from 2 to 21 (the approximate number of working days in a month). Customer accounts are divided into the same number of groups as billing dates, and each group is balanced (trial balance prepared) and billed as of its billing date. Service customers may also be naturally grouped into residential, commercial, and industrial groups. Additional subdivisions or groups are also usually used to spread work geographically, alphabetically, or arbitrarily by billing clerk.

The number of billing dates normally used is too small to use statistical sampling to select billing dates, and the auditor will need to make a judgmental selection. Two to five billing dates are common in practice. Once billing dates are selected, the auditor will usually want to identify additional natural or logical groupings within billing date trial balances to select customer balances for confirmation. The "within trial balance" selection may involve audit sampling. Typically, if there are many billing dates, the last month would be used. If there are relatively few billing dates, it is advisable to select a date or dates from the last month and an earlier month. The billing dates selected should be rotated each year.

Grouping of service customers into residential, commercial, and industrial groups can be useful for stratification of the service customer receivable population. Individually significant customer balances should be selected for 100% confirmation. Usually, these are industrial or commercial customers. Normally, audit sampling with negative confirmation requests is used for residential and smaller commercial customers. However, the auditor should consider using positive requests when controls are not effective or when billing disputes are known to be common and frequent. SAS No. 67 (AU 330.20) states that negative confirmations may be used only when:

a. the combined assessed level of inherent and control risk is low,

b. a large number of small balances is involved, and

c. the auditor has no reason to believe the confirmation recipients will not consider the requests.

The first criterion is usually not met in a small governmental audit. However, if all of the above criteria were met, the auditor may want to consider using negative confirmations. When using negative confirmations, auditors should bear in mind that negative confirmations do not provide any evidence that the requests were actually received or verified by the recipient. Therefore, negative confirmations provide only limited evidence. As a result, the use of negative confirmations is not a sampling application and the results should not be projected to the population. Because of the limited evidence provided by negative confirmations, they are best used as a supplement to evidence obtained from other auditing procedures. Generally, only positive confirmations should be used to confirm individually significant items.

Effective Analytical Procedures. Analytical procedures that provide persuasive audit evidence on the existence and completeness of service revenue and receivables can often be designed. Total service revenue can be computed by multiplying quantity of service provided during the period times the average rate; e.g., 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; e.g., an engineering record of water pumped adjusted for estimated leakage, evaporation, and faulty meters.

Accrual for Unbilled Receivables. Another feature of cycle billing with audit consequences is the need to consider the reasonableness of the estimate for unbilled receivables. Because of cycle billing, a portion of the service provided is unbilled at the end of the period. The auditor needs to review the client's accrual for unbilled receivables at the end of the period and consider reasonableness. The easiest way to consider the reasonableness of the accrual is to apply the estimated fraction of unbilled service to the next month's billings.

Sales and Pledges of Receivables and Future Revenues. As discussed earlier in this lesson, governments sometimes sell or pledge a portion of their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments—generally, a single lump sum. GASBS No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, provides guidance to governments that sell or pledge either receivables or future revenues.

SELF-STUDY QUIZ

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

24. All of the following are relevant assertions for revenues or receivables **except**:

    a. Cash reflected in the financial statements exists and transactions which pertain to the entity occurred.

    b. Receivables represent amounts uncollected at the end of the period and pertain to the entity.

    c. All revenues have been reported.

    d. Unearned revenues, receivables and deferred revenues are reported at the correct amounts.

25. In which of the following scenarios does the auditor use the proper substantive procedure for the audit of receivables?

    a. Denise Urbanosky is auditing the receivables for the City of Rising Star. She makes inquiries of responsible officials about how Rising Star raises revenue.

    b. Kim Swaim is auditing the receivables for the City of Lake Grapevine. She scans the trial balance for unusual items.

    c. Marty Goff is auditing the receivables for Tom Green Township. She determines that unrealized gains and losses are appropriately valued and properly classified.

    d. Bridget Varien is auditing the receivables for the Town of Knickerbocker. She inquires of responsible parties about their knowledge of unprocessed invoices.

26. In which of the following scenarios does the auditor use the proper substantive procedure for the audit of revenue?

    a. Gary Little is auditing revenues for the City of Mineral Wells. Gary confirms selected accounts.

    b. Paul Hensley is auditing revenues for the City of Rio Vista. Paul makes inquiries of management's use of derivatives and management's controls over them.

    c. Alan Niendorff is auditing revenues for the Town of Eden. Alan considers the allocation of revenues to the government's funds to determine if the allocation is in accordance with the intent of the governing body.

    d. Robert Martin is auditing revenues for the City of Rowena. Robert scans the account listing for related-party accounts payable.

27. In a governmental audit of revenue, the auditor is **not** able to achieve effective analytical procedures using reliable data outside the governmental unit's accounting system.

    a. True.

    b. False.

28. Select the answer choice below that best describes how governments should present their financial statements.

    a. Governments should present funds on the modified accrual basis of accounting in the governmental funds financial statements and on the accrual basis of accounting in the government-wide financial statements.

    b. Governments should present funds using the accrual basis of accounting for all statements much like any other business enterprise.

    c. Governments should present funds on the accrual basis of accounting in the governmental funds financial statements and on the modified accrual basis of accounting in the government-wide financial statements.

    d. Governments should present funds on the cash basis of accounting.

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.)**

24. All of the following are relevant assertions for revenues or receivables **except**: **(Page 319)**

    a. Cash reflected in the financial statements exists and transactions which pertain to the entity occurred. [This answer is correct. This answer choice is a relevant assertion for the audit of cash accounts.]

    b. Receivables represent amounts uncollected at the end of the period. [This answer is incorrect. This answer choice is a relevant assertion for the existence of receivables.]

    c. All revenues have been reported. [This answer is incorrect. This answer choice is a relevant assertion for the completeness of revenues.]

    d. Unearned revenues, receivables and deferred revenues are reported at the correct amounts. [This answer is incorrect. This answer choice is a relevant assertion for allocation of revenues.]

25. In which of the following scenarios does the auditor use the proper substantive procedure for the audit of receivables? **(Page 321)**

    a. Denise Urbanosky is auditing the receivables for the City of Rising Star. She makes inquiries of responsible officials about how Rising Star raises revenue. [This answer is incorrect. Denise has performed a substantive audit procedure for the audit of revenue.]

    b. Kim Swaim is auditing the receivables for the City of Lake Grapevine. She scans the trial balance for unusual items. [This answer is correct. Kim's scan of the trial balance will reveal any large credit balances, unusual names and receivables from known related parties.]

    c. Marty Goff is auditing the receivables for Tom Green Township. She determines that unrealized gains and losses are appropriately valued and properly classified. [This answer is incorrect. Marty has performed a substantive audit procedure for investments.]

    d. Bridget Varien is auditing the receivables for the Town of Knickerbocker. She inquires of responsible parties about their knowledge of unprocessed invoices. [This answer is incorrect. Bridget has performed a substantive audit procedure for payables.]

26. In which of the following scenarios does the auditor use the proper substantive procedure for the audit of revenue? **(Page 322)**

    a. Gary Little is auditing revenues for the City of Mineral Wells. Gary confirms selected accounts. [This answer is incorrect. Gary has performed substantive audit procedures applicable to the audit of receivables.]

    b. Paul Hensley is auditing revenues for the City of Rio Vista. Paul makes inquiries of management's use of derivatives and management's controls over them. [This answer is incorrect. Paul has performed substantive audit procedures applicable to the audit of investments.]

    c. Alan Niendorff is auditing revenues for the Town of Eden. Alan considers the allocation of revenues to the government's funds to determine if the allocation is in accordance with the intent of the governing body. [This answer is correct. Many times governments must allocate revenues to various funds in accordance with law or statute.]

    d. Robert Martin is auditing revenues for the City of Rowena. Robert scans the account listing for related-party accounts payable. [This answer is incorrect. Robert has performed substantive audit procedures applicable to the audit of payables.]

27. In a governmental audit of revenue, the auditor is **not** able to achieve effective analytical procedures using reliable data outside the governmental unit's accounting system. **(Page 322)**

    a. True. [This is incorrect. Effective analytical procedures can be obtained on certain items of outside data. An example of this would be property taxes.]

    b. False. [This answer is correct. Effective analytical procedures for revenues of governmental funds can often be designed based on reliable data from outside the governmental unit's accounting system.]

28. Select the answer choice below that best describes how governments should present their financial statements. **(Page 322)**

    a. Governments should present funds on the modified accrual basis of accounting in the governmental funds financial statements and on the accrual basis of accounting in the government-wide financial statements. [This answer is correct. The basis for revenue recognition for a government unit is different than in the business sector because the concept of earning revenue is less relevant; therefore modified accrual basis accounting is relevant for funds financial statements.]

    b. Governments should present funds using the accrual basis of accounting for all statements much like any other business enterprise. [This answer is incorrect. Governmental entities measure revenues differently than business enterprises. For example, a governmental unit recognizes income when it is measurable and available and a business enterprise recognizes income when it is earned.]

    c. Governments should present funds on the accrual basis of accounting in the governmental funds financial statements and on the modified accrual basis of accounting in the government-wide financial statements. [This answer is incorrect. This answer choice recognizes a difference between fund financial statements and government-wide financial statements; however, the relationship is not accurate.]

    d. Governments should present funds on the cash basis of accounting. [This answer is incorrect. GASB 34 includes in-depth information of the accounting requirements for revenues and receivables. Accounting for revenues and receivables using cash basis accounting is not an option under GASB 34.]

Expenditures for Goods and Services, Expenses, and Accounts Payable and Other Liabilities

Unique Considerations for Auditing Expenditures/Expenses and Accounts Payable of a Governmental Entity. Resource outflows are classified in governmental financial statements in various ways. In the government-wide statement of activities, they are reported as expenses (generally classified by function or different identifiable activity) or special or extraordinary items. In governmental funds, they are reported as expenditures, other financing uses, special items, or extraordinary items. In proprietary funds, resource outflows are classified as operating expenses, nonoperating expenses, special items, or extraordinary items. Trust funds classify resource outflows as "deductions." Regardless of the fund type or activity being reported, expenditures/expenses and liabilities should be reported in a consistent manner from year to year.

GASBS No. 38, *Certain Financial Statement Note Disclosures*, requires governments to provide details in the notes when significant components of payables have been obscured by aggregation. However, the financial statements may present separate lines for liabilities related to operating expenditures/expenses (for example, vouchers payable, accrued liabilities, and claims and judgments payable).

Many governments have centralized purchasing, accounts payable, and cash disbursement activities. Small governments typically have a single control system for ordering and receipt of goods and services, accounting for expenditures and liabilities, and cash disbursements. Larger governments often have multiple systems to control ordering and receipt of goods and services (e.g., purchasing offices for individual departments), but account for expenses and liabilities and make cash payments through a single system. Some governments also have specialized processes to handle small-dollar purchases, such as petty cash funds or the use of purchase cards. Occasionally, governments have separate control systems for grant programs or for certain departments. Frequently, certain disbursements are made by another entity, such as a financial institution that makes payments to bondholders.

The extent of a governmental unit's internal control usually will be different for different types of transactions. For example, controls over payroll and related transactions may be more stringent than controls over contracts for goods and services. The auditor should consider the different levels of internal control and control risk for different types of costs when designing the audit approach.

SLG, paragraph 8.116, explains that the auditor might determine a governmental unit's types of expenditures/expenses and liabilities by performing procedures such as, reading relevant documents (e.g., budgets, enabling legislation, and grant agreements) for legal and contractual provisions; reading minutes of governing board and committee meetings; asking appropriate officials about functions, programs, and resource use; and reviewing prior-period and draft financial statements or other accounting information for the current period.

New Requirements for Governments in Chapter 9 Bankruptcy. GASBS No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, which was issued in December 2009, provides guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. GASBS No. 58 is effective for reporting periods that began after June 15, 2009. Retroactive application is required for all prior periods presented during which a government was in bankruptcy.

GASBS No. 58 requires governments to remeasure liabilities that were adjusted in bankruptcy upon court approval of a new payment plan. Remeasurement of a contractual obligation to pay on demand or on fixed or determinable dates, such as accounts payable, should be based on the new payment plan. A gain is reported for the excess of the carrying amount over the adjusted amount payable.

Compliance Requirements. The expenditure/expense and liabilities activities of governments often are subject to various compliance requirements, such as:

- Budgetary constraints may limit spending for particular funds, functions, departments, or object classes.
- State and local laws and regulations, debt agreements, and grant agreements often require competitive bidding for large purchases. Also, certain vendors may be barred from providing goods or services.
- Grants, entitlements, contributions, and trust agreements may require that funds be spent for particular purposes, during a particular period, or that matching funds be provided. They also may require that cash

be disbursed within a short time after its receipt by the government. Governments are sometimes permitted to allocate indirect costs to a grant (often based on an approved indirect cost allocation plan or rate).

GAAS establish the auditor's responsibility for compliance at the level of compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

Relevant Assertions for Expenditures/Expenses and Liabilities. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for expenditures/expenses and accounts payable are as follows:

- Existence or occurrence (E/O)—Reported expenditures/expenses represent amounts relating to the period and pertain to the entity. Reported liabilities represent amounts unpaid as of the end of the period. Disclosed expenditures/expenses and liabilities have occurred and pertain to the entity.

- Completeness (C)—All expenditures/expenses related to the period and all liabilities as of the end of the period have been reported. All required disclosures have been included in the financial statements.

- Rights or obligations (R/O)—Conditions and agreements that affect the entity's liabilities as of the end of the period have been properly reflected in the financial statements.

- Valuation or allocation (V)—Liabilities are reported at appropriate amounts. Information pertaining to expenditures/expenses and liabilities is disclosed at appropriate amounts.

- Accuracy or classification (A/CL)—Amounts and other data relating to expenditures/expenses have been recorded appropriately and in the proper accounts. Financial information relating to expenditures/expenses and liabilities is appropriately presented and described and is disclosed fairly and at appropriate amounts in accordance with GAAP. Disclosures are clearly expressed.

- Cutoff (CO)—Expenditures/expenses have been recorded in the correct accounting period.

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

Substantive Audit Procedures for Expenditures/Expenses, Accounts Payable, and Other Liabilities. The auditor obtains evidence for expenditures/expenses and liabilities primarily through reviewing governing body minutes; reviewing grant and contribution agreements and correspondence from grantor agencies, contributors, and others; reviewing other supporting documents; inquiring of management and others; and performing analytical procedures to obtain evidence about the following matters:

- Whether the governmental unit is in compliance (during the year and at year end) with compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

- Whether the governmental unit adheres to its policy concerning first applying restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

- Whether expenditures/expenses and liabilities are properly recorded and classified.

- Whether encumbrances at year end for outstanding contracts and purchase orders are valid and are recorded and reported in conformity with GAAP.

- Whether the governmental unit has appropriately reversed long-outstanding checks and whether unclaimed amounts have been handled properly in accordance with escheat laws.

- Whether expenditures/expenses, liabilities, and commitments are measured, presented, and disclosed in the financial statements in conformity with GAAP.

Substantive Audit Procedures for Accounts Payable and Other Liabilities. The audit of accounts payable and other liabilities concentrates primarily on the financial statement assertions of completeness, cutoff, and the presentation and disclosure assertions of accuracy/classification. The other assertions—existence/occurrence, rights/obligations, and valuation—are addressed within the audit procedures designed to test the primary assertions. Examples of substantive procedures for accounts payable and other liabilities are as follows:

- Compare the balances in accounts payable and other liabilities with those of prior years or other auditor-developed expectations. Investigate any unusual fluctuations, considering known changes in the client's activities.

- Inquire of the client about their knowledge of unprocessed invoices and trace receiving cutoff information to the accounting records, noting whether the liability is recorded in the proper accounting period.

- Scan the listings of accounts payable and other liabilities for amounts payable to related parties and any other unusual items and consider whether appropriate financial statement disclosures have been made.

Substantive Audit Procedures for Expenditures/Expenses. The interrelationship of liabilities and expenditures/expenses may allow auditors to conclude that they have obtained, completely or in part, sufficient appropriate audit evidence for relevant assertions related to expenditures/expenses by application of procedures directed to relevant assertions related to accounts payable and other liabilities.

Assuming the auditor's substantive audit procedures for accounts payable and other liabilities provide sufficient appropriate audit evidence, analytical procedures such as the following will generally provide sufficient appropriate audit evidence for relevant assertions related to expenditures/expenses:

- Compare balances in expenditure/expense accounts by function, program, and opinion unit with those of prior years and with budgeted amounts or other auditor-developed expectations. Determine that expenditures/expenses are recorded correctly as to account, fund, budget category, period, and amount. Investigate any unexpected variations.

- Compute the ratio of individual expenditure/expense accounts to total expenditures/expenses (for the function, program, or opinion unit) and compare to prior-year ratios. Investigate any unexpected variations.

- Scan the accounting records, including nonstandard journal entries, and obtain an understanding of the business rationale for any large and unusual transactions.

Audit Program for Expenditures/Expenses and Accounts Payable and Other Liabilities. A core audit program presents basic, extended, and additional substantive audit procedures for expenditures/expenses and accounts payable and other liabilities. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for expenditures/expenses and accounts payable and other liabilities that are normally adequate to respond to a set of underlying risk assessments considered typical of many governments.

Accounting and Budgetary Considerations. Expenditures represent decreases in the financial resources of a governmental fund. Expenditures for goods and services include operating, debt service, and capital expenditures. Under the modified accrual basis of accounting used in governmental fund financial statements, financial resources represent the amount available to meet the commitments of the governmental fund in question. The unique considerations in auditing governmental expenditures relate to budgetary and legal compliance and the timing of expenditure recognition.

Governmental fund expenditures should be recognized when the related liability is incurred or a capital asset is acquired, whether or not the expenditure has been budgeted. An expenditure is recognized when a capital asset is acquired because the capital asset does not represent a financial resource that can be used to satisfy future monetary commitments. When testing expenditures, the auditor should obtain evidence about their compliance with the budget and with other laws and regulations. To do this, the auditor has to be familiar with the budget adopted by the governing body and the other legal documents that define and limit the powers of the governmental unit.

Even if the governmental unit's budgetary comparison information is not audited, the auditor might decide to perform audit procedures relating to the budget to consider, for example, controls to ensure that expenditures/expenses have been properly approved, monitored, enforced, and classified. Because governmental budgets typically have the force of law, they are incorporated into the accounting structure and are an integral part of internal controls. The auditor should obtain an understanding of these controls, evaluate their design, and determine whether they have been implemented. If the budgetary controls are in place and functioning properly, the auditor may be able to assess control risk for expenditures/expenses at low to moderate and use that assessment as a basis for determining the nature, timing, and extent of substantive procedures.

The government-wide financial statements are prepared on the accrual basis of accounting. Adjustments are generally prepared at the report level to reflect accrual activity in the governmental activities column of the government-wide financial statements. The auditor should determine that the information necessary to report all material expenses (on the accrual basis of accounting) not already reflected in the information to prepare the fund financial statements is available and has been considered. GASBS No. 34 requires governments to report all expenses in their government-wide financial statements by function except for those that meet the definitions of special items or extraordinary items. (Transfers, which are neither revenues nor expenses, should also be excluded from program expenses.) At a minimum, governments should report direct expenses for each function.

Accounting System Considerations. The auditor should obtain an understanding of the governmental unit's procurement system by obtaining information such as the following: Is the purchasing function centralized or decentralized? What are the principal types of goods and services acquired, and who are the principal suppliers? Are competitive bidding practices followed? What are the primary methods used for purchasing; e.g., contracts, blanket purchase orders, etc.? What are the billing practices of vendors? What laws, regulations, and policies apply to budgetary control of expenditures and use of encumbrances?

The simple fact that a procurement system is in place may offer some control over inappropriate acquisition decisions and waste of government resources. It is not unusual for even a small local governmental unit to have a purchasing function that is separate from the unit's operating departments. If the governmental unit uses a single purchasing, accounts payable, and disbursements system disbursements may be selected from a single population of expenditures. Although enterprise funds use the accrual basis of accounting, which differs from the basis used by governmental funds, the expenditures of all funds may be tested as one population if all expenditures are processed using the same system. In other cases, the auditor has to identify the significant disbursements systems and test each one individually.

As noted earlier, the auditor needs to identify the legal requirements pertinent to purchasing activities (e.g., competitive bidding) and requirements imposed by local or state ordinance, bond covenants, grant provisions, etc., on various categories of expenditures. Obtaining an understanding of legal requirements does consume audit time, but the existence of such requirements is an aid to the auditor. Requirements for public notice of proposed acquisitions, public disclosure of acquisition procedures, and billing procedures each may provide reliable controls over, and audit evidence about, expenditures.

Importance of Proper Classification. In testing the accounting accuracy of expenditures, audit procedures are directed to obtaining reasonable assurance that expenditures for goods or services and related disbursements and liabilities have been recorded correctly as to account, fund, budget category, period, and amount. Expenditures may be intentionally misclassified or recorded at the wrong amount or in the wrong period to avoid exceeding the budget.

Use of Audit Sampling. Because of the importance of classification, a basic procedure in the audit program for expenditures is to select a sample of expenditures (concurrently with cash disbursements) and review them for correctness of account distribution, agreement of details with supporting documents, and recording in the correct period. Since the auditor's primary concern in sampling expenditures is to test transaction processing, the most efficient sampling technique is the attribute sampling approach to substantive tests of transactions.

Relation to Other Audit Areas. The results of testing the accounting accuracy of a sample of expenditures have a direct bearing on the scope of audit work in other audit areas; e.g., the results should be evaluated in considering the size of the cutoff amount used in the search for unrecorded accounts payable. Weaknesses in recording expenditures and disbursements for goods or services should result in lowering the cutoff amount; i.e., expanding the test. Conversely, if processing of expenditures is effective, the cutoff amount used in the search can be raised and the scope thereby restricted.

The results of testing expenditures may also affect the scope of work on capital expenditures and debt service expenditures. In selecting a sample of expenditures, it is usually efficient to define cash disbursements as the sample unit. Thus, the sample may include expenditures for capital assets or debt service. If processing of expenditures is effective, the cutoff amount for individually significant items in these areas can be raised to reduce the scope of work. Generally, if processing is effective, a cutoff amount closer to one-third of tolerable misstatement for the relevant fund type may be used, and if processing is less than effective, the cutoff amount should be lowered.

Encumbrances. An encumbrance system may be used to help ensure that expenditures do not exceed budget appropriations for an expenditure category. To account for encumbrances, the governmental unit reduces the amount of budgetary authority remaining in the budget category and records an outstanding encumbrance when a purchase order or commitment is placed. When the goods or services have been received, the encumbrance balance is reduced and the expenditure and a liability is recorded. Encumbrance systems provide assurance that proposed expenditures are allowed by the budget and thus help ensure that budgets will not be overexpended. When an encumbrance system is used, the auditor's tests of expenditures should check that encumbrances are relieved when goods or services are received.

SELF-STUDY QUIZ

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

29. Which of the following audit assertions is relevant to the cutoff assertion as it relates to expenditures?

    a. Insurance and self-insurance revenues are recorded in the proper accounting period.

    b. Grants revenues and expenditures charged to grants are recorded in the proper accounting period.

    c. Accrued liabilities are recorded in the proper accounting period.

    d. Expenditures/expenses have been recorded in the correct accounting period.

30. Listed below are substantive audit procedures for Accounts Payable and other liabilities and expenditures/expenses. Properly match the accounts under audit with the audit procedure.

ACCOUNTS	AUDIT PROCEDURES
A. Accounts payable and other liabilities	i. Compare balances in accounts with those of prior years and budgeted amounts.
B. Expenditures/expenses	ii. Investigate any unusual fluctuations.
	iii. Inquire about unprocessed invoices.
	iv. Consider whether appropriate financial statement disclosures have been made.

    a. A with ii, iii and iv; B with i and ii.

    b. A with i, ii, iii and iv; B with i, ii, iii and iv.

    c. A with iv ; B with i.

    d. A with iii and iv; B with i and ii.

31. Select the answer choice that best describes why it is important for an auditor to obtain an understanding of the legal requirements pertinent to purchasing activities.

    a. Having a procurement system in place may offer some control over inappropriate acquisition decisions.

    b. Requirements for public notice and public disclosure over proposed acquisitions may provide audit evidence about expenditures.

    c. Knowing whether the purchasing system is centralized or decentralized will assist the auditor with the selection of substantive audit procedures.

    d. The auditor should have an understanding of the billing practices of vendors to help understand any fluctuations in expenditures.

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.)**

29. Which of the following audit assertions is relevant to the cutoff assertion as it relates to expenditures? **(Page 334)**

    a. Insurance and self-insurance revenues are recorded in the proper accounting period. [This answer is incorrect. This audit assertion applies to the cutoff for insurance and self-insurance.]

    b. Grants revenues and expenditures charged to grants are recorded in the proper accounting period. [This answer is incorrect. This audit assertion applies to the cutoff for grant revenues and expenditures.]

    c. Accrued liabilities are recorded in the proper accounting period. [This answer is incorrect. This audit assertion applies to the cutoff for accrued liabilities.]

    d. Expenditures/expenses have been recorded in the correct accounting period. [This answer is correct. This answer choice properly relates the audit assertion to the cutoff for expenditures.]

30. Listed below are substantive audit procedures for Accounts Payable and other liabilities and expenditures/expenses. Properly match the accounts under audit with the audit procedure. **(Page 341)**

ACCOUNTS	AUDIT PROCEDURES
A. Accounts payable and other liabilities	i. Compare balances in accounts with those of prior years and budgeted amounts.
B. Expenditures/expenses	ii. Investigate any unusual fluctuations.
	iii. Inquire about unprocessed invoices.
	iv. Consider whether appropriate financial statement disclosures have been made.

    a. A with ii, iii and iv; B with i and ii. [This answer is correct. Substantive procedure i does not apply to Accounts Payable and other liabilities as the amount of Accounts Payable and other liabilities generally is not budgeted. Only expenditures are budgeted. Substantive procedures iii and iv do not apply to Expenditures as the auditor is generally trying to determine if Accounts Payable and other liabilities are complete by looking for unprocessed invoices. Generally financial statement disclosures are made on balance sheet accounts such as accounts payable rather than accounts classified as expenses.]

    b. A with i, ii, iii and iv; B with i, ii, iii and iv. [This answer is incorrect. Not all the substantive procedures apply to both audit areas.]

    c. A with iv ; B with i. [This answer is incorrect. These audit areas are subject to additional substantive procedures listed in the choices i through iv.]

    d. A with iii and iv; B with i and ii. [This answer is incorrect. An important concept concerning substantive audit procedures is either missing from or misapplied to this answer.]

31. Select the answer choice that best describes why it is important for an auditor to obtain an understanding of the legal requirements pertinent to purchasing activities. **(Page 334)**

    a. Having a procurement system in place may offer some control over inappropriate acquisition decisions. [This answer is incorrect. While it is true that having a procurement system in place may offer some control over inappropriate acquisition decisions; this answer choice does not relate to the auditor's understanding of the legal requirements pertinent to purchasing activities.]

    b. Requirements for public notice and public disclosure over proposed acquisitions may provide audit evidence about expenditures. [This answer is correct. This answer choice relates the legal requirements of a procurement system to the reason why the auditor should become familiar with the legal requirements.]

    c. Knowing whether the purchasing system is centralized or decentralized will assist the auditor with the selection of substantive audit procedures. [This answer is incorrect. A centralized or decentralized procurement system is not a legal requirement of a procurement system.]

    d. The auditor should have an understanding of the billing practices of vendors to help understand any fluctuations in expenditures. [This answer is incorrect. While it is accurate that the auditor will need to be familiar with the billing practices of vendors, this answer choice does not relate the legal requirement of the procurement system.]

Pollution Remediation Obligations. GASBS No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, establishes standards for pollution remediation obligations. These are obligations to address the detrimental effects (both currently existing and potential effects) of existing pollution by engaging in pollution remediation activities such as site assessments and cleanups.

Required Disclosures. GASBS No. 49 requires governments to disclose the following about recognized pollution remediation obligations:

- The nature and source of the obligations (for example, federal, state, or local laws).

- The estimated liability (if not apparent from the financial statements), the methods and assumptions used to make the estimate, and the potential that the estimate may change because of, for example, price increases, technology, or applicable laws or regulations.

- Estimated recoveries used to reduce the liability.

If pollution remediation liabilities are not recognized in the financial statements because the entire liability or components of it are not yet reasonably estimable, governments should provide a general description of the nature of the pollution remediation activities.

Payroll and Related Liabilities

Relevant Assertions for Payroll and Related Liabilities. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for payroll and related liabilities are as follows:

- Existence or occurrence (E/O)—Payroll transactions reported in the financial statements exist and represent valid transactions that occurred during the period. Payroll disbursements are made only for work authorized and performed.

- Completeness (C)—All payroll expenditure/expense transactions that should be included in the financial statements are included. Payroll liabilities presented in the financial statements represent a complete presentation of the governmental unit's obligations required by GAAP to be presented.

- Rights or obligations (R/O)—Payroll related liabilities reflected in the financial statements are obligations of the governmental unit. Payroll is computed using rates and other factors in accordance with contracts and relevant laws and regulations.

- Valuation or allocation (V)—Payroll related liabilities are valued in accordance with GAAP. Payroll and related liabilities are recorded correctly as to amount and period and distributed properly.

- Accuracy or classification (A/CL)—Payroll transactions and payroll related liabilities are properly presented in the financial statements. Information on payroll and related liabilities required by GAAP is fairly disclosed and at appropriate amounts.

- Cutoff (CO)—Payroll transactions and related liabilities are recorded in the proper accounting period.

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

Substantive Audit Procedures for Payroll and Related Liabilities. The audit of payroll and related liabilities is similar to that for expenditures/expenses and accounts payable and other liabilities. Examples of substantive procedures for payroll and related liabilities are as follows:

- Compare payroll expenditures/expenses to prior-period actual and current budget (by function/program and in total) and relate to number of personnel (by function/program and in total) or other auditor-developed expectations. If meaningful, compute the average payroll cost per employee and compare to prior periods. Investigate unexpected variations.

- Compare accruals for compensated absences to the prior period actual and current budget and compare the relationship of amounts to gross pay with the same ratio for the prior period or other auditor-developed expectations. Investigate unexpected variations.

- Compare pension expenditures/expense per number of covered employees to the same ratio for the prior period or other auditor-developed expectations. Investigate unexpected variations.

- Compute the ratio of payroll tax and other employee benefit expenditures/expense at the end of the period to total payroll and compare with the ratios of prior years or other auditor-developed expectations. Investigate unexpected variations.

- Consider the reasonableness of accrued payroll at the end of the period by performing a predictive test such as comparing it to the subsequent payroll run or other auditor-developed expectations. Investigate unexpected variations.

Audit Program for Payroll and Related Liabilities. A core audit program presents basic, extended, and additional substantive audit procedures for payroll and related liabilities. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for payroll and related liabilities that are normally adequate to respond to a set of underlying risk assessments considered typical of many governments.

Audit procedures for payroll depend on considerations such as whether different payroll systems are used for salaried and hourly employees or other categories of employees; the size, location, and relative stability of the work force; whether some or all employee groups are unionized; what civil service requirements exist for addition or deletion of employees; and what benefit plans are in effect.

Relation of Legal Requirements to Audit Risk. Civil service and personnel merit systems control abuses of governmental employment. Elaborate procedures are often necessary to remove and add individuals to the government payroll. This may, for example, reduce the possibility of payroll padding. Compliance with such systems may be overridden, however, and some operations of the governmental unit may be outside those controls; e.g., public utilities or hospitals. Thus, the auditor should inquire about regulations pertinent to wages, salaries, and benefits and read relevant civil service regulations, local, state, and federal ordinances, and other regulations.

Analytical Procedures. The auditor's objectives in this area are to obtain reasonable assurance that payroll (wages, salaries, and benefits) disbursements are made only for all work authorized and performed; payroll is computed using rates and other factors in accordance with contracts and relevant laws and regulations; and payroll and related liabilities are recorded correctly as to amount and period and distributed properly by account, fund, and budget category.

Often the auditor is able to use effective analytical procedures and efficient tests of payroll totals to substantially achieve audit objectives. An analytical procedure 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). An absence of significant fluctuations can justify omission of sampling individual payroll transactions or, if sampling is considered necessary in the circumstances, a significant reduction in sample size. 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.

Another effective overall test for payroll is to reconcile payroll record totals to comparable totals on Form 941 filed by the governmental unit. Because of the reduced audit risk resulting from legal requirements and the unlikelihood of filing false forms with a federal agency, this procedure is often very efficient and effective. When the analytical tests and this procedure produce satisfactory results, it is not usually necessary to sample individual payroll transactions.

Pension Plans. GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*, contain the pension standards for governments. Those standards establish extensive accounting and reporting requirements. GASBS No. 50, *Pension Disclosures*, modified the requirements of GASBS Nos. 25 and 27. A detailed discussion of all the requirements is provided in *PPC's Guide to Preparing Governmental Financial Statements Under GASBS No. 34*.

Those standards establish extensive accounting and reporting requirements. GASBS No. 50, *Pension Disclosures*, modified the requirements of GASBS Nos. 25 and 27. A detailed discussion of all the requirements is provided in *PPC's Guide to Preparing Governmental Financial Statements Under GASBS No. 34*.

GASBS No. 27 establishes the requirements for an employer's accounting and reporting for pension plans. It requires actuarial methods and assumptions used by employers for financial reporting purposes to be consistent with methods and assumptions used by the plan for financial reporting purposes. It also links the employer's measure of pension cost for financial reporting purposes with the required contributions for funding purposes. GASBS No. 27 also provides disclosure requirements for both defined benefit and defined contribution pension plans.

GASBS No. 50, *Pension Disclosures*, modifies the disclosure requirements of GASBS No. 27 and makes the employer financial statement disclosures about pension plans consistent with those required for OPEB plans. These disclosures primarily relate to funding policies, the funded status of the plan, and the approximate funded status of the plan when the aggregate actuarial cost method is used. Because the new disclosures are in the notes to the financial statements (rather than in notes to the RSI), it is important to remember that they are subject to audit procedures. In addition, GASBS No. 50 requires governments that use the aggregate actuarial cost method to present required supplementary information (RSI) about funding progress using the entry age actuarial cost method as a surrogate method.

OPEB. GASB Statement No.43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and GASBS No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, contain the OPEB standards for governments.

Effective Dates. GASBS No. 43 became effective retroactively in three phases using the definition of phases established by GASBS No. 34. Phase I governments were required to implement the new OPEB requirements for periods beginning after December 15, 2005. Phase 2 and phase 3 governments were required to implement GASBS No. 43 in periods beginning after December 15, 2006 and 2007, respectively. GASBS No. 45 is effective one year later than GASBS No. 43. GASBS No. 45 is effective prospectively in three phases using the definition of phases established by GASBS No. 34. Phase I and phase 2 governments were required to implement the new OPEB requirements for periods beginning after December 15, 2006 and December 15, 2007, respectively. Phase 3 governments are required to implement GASBS No. 45 in periods beginning after December 15, 2008.

OPEB are defined as postemployment benefits other than pensions that employees earn during their years of service but that they will not receive until after they stop working. They include all postemployment healthcare benefits. They also include any other type of benefits that are provided separately from a pension plan, such as life insurance, legal services, and any other benefits that the employer may provide. OPEB exclude any non-healthcare benefits provided through a pension plan. Nonhealthcare benefits provided as part of a termination offer are also excluded.

The basic premise of GASBS No. 45 is that OPEB are earned and should be recognized when the employee provides services, just like wages or salaries paid at the end of each pay period. But because these benefits cannot be used until the employee is no longer working, they are not paid in cash until a date that may extend well into the future.

GASBS No. 45 requires employers to measure OPEB expenditures/expenses in much the same way that GASBS No. 27 measures pension expenditures/expenses. This includes the concept that annual OPEB cost would equal the annual required contribution (ARC) to the plan, provided the ARC is calculated within specified parameters and the employer makes a contribution equal to the ARC each year. The requirements apply regardless of whether the government finances OPEB on a pay-as-you-go basis or has a formal trust plan. Unlike GASBS No. 27, however, the OPEB liability at transition for single employer and multiple employer plans is zero.

The ARC and annual OPEB cost are determined using one of six actuarial cost methods described in the statement. However, small single-employer plans—those with fewer than one hundred members—and the employers that participate in them can estimate the ARC using simplified methods and assumptions. GASBS No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, clarifies that the option to use the alternative, simplified method is also available to employers in agent multiple-employer plans if the employer's plan has fewer than 100 plan members. Best practices indicate that the auditor should consider performing the following procedures when determining the reasonableness of OPEB amounts reported in the employer's financial statements:

- Compare the data given to OPEB plan actuaries to the client's records and investigate unexpected variations.
- Consider the reasonableness of the discount rate used by OPEB plan actuaries. (The discount rate may be higher than can be justified.)

<u>Required Disclosures.</u> The disclosures required by GASBS No. 45 are similar to GASBS No. 27, including information about required contributions for the current and preceding two years, amounts actually contributed, and funded ratios. Disclosures apply even if the government is funding OPEB on a pay-as-you-go basis. GASBS No. 45 requires all employers participating in defined benefit plans to disclose specific information about the plan description and funding policy in the notes to the financial statements. GASBS No. 45 also requires employers participating in single-employer or agent multiple-employer plans to make certain other disclosures and to provide specific RSI. Employers that use the aggregate actuarial cost method have to present RSI using the entry age actuarial cost method.

In the year that an employer first adopts GASBS No. 45, the employer should make the following disclosures for each single-employer, agent, and cost-sharing plan, even if the OPEB liability (asset) was zero both before and at the effective date:

- A comment either that GASBS No. 45 was implemented prospectively (zero net OPEB obligation at transition) or that an OPEB liability or asset at transition was determined in accordance with GASBS No. 45.
- The amount of the OPEB liability or asset at transition, if any, and the difference, if any, between that amount and any previously reported liability or asset to the same plan.

Termination Benefits. GASBS No. 47, *Accounting for Termination Benefits*, establishes accounting and reporting requirements for all termination benefits. GASBS No. 47 has two effective dates, depending on whether the termination benefits affect the employer's obligations for defined benefit OPEB. When benefits affect defined benefit OPEB obligations, GASBS No. 47 is effective at the same time that the employer adopts GASBS No. 45. In all other cases, GASBS No. 47 should be applied in financial statements for periods beginning after June 15, 2005.

<u>Financial Statement Presentation.</u> The following items discuss the financial statement presentation of termination benefits:

- *Governmental Funds.* Only the portion of the expenditure and liability for termination benefits that is "normally expected to be liquidated with expendable available financial resources" should be reported in governmental type funds; the remainder should be reported as a general long-term liability in the governmental activities column in the government-wide statement of net assets.

- *Proprietary and Trust Funds.* The entire liability should be reported as a fund liability. Termination benefits expenses may be reported as part of employee compensation and benefits expense or may be reported on a separate line in the proprietary fund statement of revenues, expenses, and changes in fund net assets. Proprietary funds are required to present a classified statement of net assets and therefore must report material amounts of current and noncurrent termination benefits liabilities on separate lines in the statement of proprietary fund net assets.

- *Government-wide Statements.* Termination benefits (expenses and liabilities) should be reported using the accrual basis of accounting. Liabilities with average maturities greater than one year should be reported in two components—due within one year and due in more than one year. In the government-wide statement of activities, governments are required to report direct expenses for each function/identifiable activity presented. This may require a reclassification of amounts, depending on how they were reported in the fund financial statements.

<u>Required Disclosures.</u> GASBS No. 47, paragraphs 18 through 21, establish disclosure requirements when an employer provides termination benefits. In the year in which the government first becomes obligated to pay termination benefits (as well as in any other period in which employees must continue to provide services to receive those benefits), governments should disclose:

a. A description of the termination benefit arrangement.

b. The cost of the benefits, if that information is not already evident from the face of the financial statements.

c. The change in the actuarial accrued liability arising from termination benefits that affect the employer's defined benefit or OPEB obligations.

If the employer does not report a portion of the liability for termination benefits because it is not measurable, that fact should be disclosed.

Compensated Absences. GASB Statement No. 16, *Accounting for Compensated Absences*, provides guidance on the measurement of accrued compensated absences, regardless of the reporting model or fund type used to report the transactions. Compensated absences are absences for which the employee will be paid, including vacation, sick leave, and sabbatical leave.

Simply stated, a liability for compensated absences that are attributable to services already rendered and that are not contingent on a specific event that is outside the control of the employer and employee should be accrued as employees earn the rights to the benefits. Compensated absences that relate to future services or that are contingent on a specific event that is outside the control of the employer and employee should be accounted for in the period those services are rendered or those events take place.

<u>Vacation Leave and Other Compensated Absences.</u> The liabilities for vacation leave and other compensated absences, excluding sick leave, will be accrued when the benefits are earned by the employee if the leave is attributable to past service and it is probable that the employer will compensate the employee through paid time off or some other means, such as cash payments at termination or retirement. Benefits that have been earned but that are not yet available for use because certain conditions have not been met should be accrued to the extent that it is probable that the employees will meet these conditions in the future. An example of such a condition would be a minimum service period for new employees. However, benefits that have been earned but that are expected to lapse should not be accrued. A benefit would be expected to lapse if an employer required that excess days above an allowed accrual amount must be forfeited without payment if not taken by a certain date.

<u>Sick Leave and Other Compensated Absences with Similar Characteristics.</u> There are two suggested treatments for accrual of sick leave and other compensated absences with similar characteristics; e.g., jury duty, an absence which is contingent on a specific event that is outside the control of the employer and employee. Although appointments for medical and dental wellness visits are not outside the control of the employee, they are treated as sick leave because it is cost-beneficial to do so. In accounting for sick leave, the substance of an employer's practice should prevail over the form of its policies. For example, some employers may call a benefit "sick leave" even though the absence from work is not the result of an illness. These absences should be treated as "vacation or other compensated absences" under Statement No. 16.

The two alternative methods for sick leave accrual are as follows:

- *Termination Payment Method.* Under this method, sick leave can be accrued as a liability when the benefit is earned and to the extent that it is probable that the employee will be paid for the benefit upon termination or retirement. Therefore, accrual would not be made for those absences that are expected due to illness. The accrual would be based on an estimate of past experience with termination payments for sick leave, adjusted for the effect of changes in termination payment policies and other current factors.

- *Vesting Method.* Under this method, the liability can be measured based on the sick leave accumulated at the balance sheet date by those employees who are currently eligible to receive termination payments as well as other employees who are expected to become eligible in the future to receive such payments. In calculating the liability, these accumulations should be reduced to the maximum amount allowed as a termination payment. Amounts in excess of the maximum for which payment is allowed at termination would be excluded because those balances are available only for use as paid time off for illness. Accruals for future eligibility should be based on assumptions concerning the probability that individual employees or classes of employees will become eligible to receive termination payments.

Sabbatical Leave. The accrual for sabbatical leave depends on whether the compensation paid during the sabbatical is for service during the period of the leave or for past service. A liability should not be accrued for payments for service during the period of the leave. This would be the case when an employee is granted leave to perform research or public service or to obtain additional training that would benefit the employer. In effect, this is a change of duties, and the salary payments are compensation for services rendered during the period of the leave. If sabbatical leave is permitted as compensation for past service, the liability should be accrued during the periods that the employee earns the right to the leave if it is probable that it will be taken.

Liability Calculation. The liability should be calculated based on the pay or salary rates in effect at the balance sheet date, even if a pay increase has been approved before the end of the year to take effect the first day of the following year. However, if the compensated absence is paid at other than the pay or salary rate (e.g., a contract rate), that rate should be used to calculate the liability.

Direct and Incremental Salary-related Payments. An additional accrual should be made for salary-related payments such as the employer's share of social security taxes and the employer's contribution to a defined contribution or cost-sharing multiple-employer defined benefit pension plan. These payments are called "direct and incremental salary-related payments" in the Statement. Accrual should be made for the full liability for each type of compensated absence to which salary-related payments apply. However, the accrual rate for social security taxes may be less than the full rate if employees earn more than the applicable wage base for the tax.

Financial Statement Presentation. The following items discuss the financial statement presentation of compensated absences.

- *Governmental Funds.* Governmental fund types are required to report the current portion of the liability for compensated absences. For example, the only portion of a vacation pay liability to be reported in a governmental fund is the amount of unused and unpaid vacation leave payable to employees who had terminated their employment at year end.

- *Proprietary and Trust Funds.* The entire amount of the compensated absences liability should be reported as a fund liability. Compensated absence expenses should be reported as part of employee compensation and benefits expense in the proprietary fund statement of revenues, expenses, and changes in fund net assets. Proprietary funds are required to present a classified statement of net assets and therefore must report material amounts of current and noncurrent compensated absences liabilities on separate lines in the statement of fund net assets. Governments should estimate the current amount, giving consideration to amounts budgeted for the next fiscal year, historical trends, and any other factors such as the government's policy regarding whether absences carried over from previous years must be used before amounts earned in the current year.

- *Government-wide Statements.* The entire amount of compensated absences expenses and liabilities (accrual basis) should be reported. Liabilities with average maturities greater than one year should be reported in two components—due within one year and due in more than one year. In the government-wide statement of activities, governments are required to report direct expenses for each function/identifiable activity presented. This may require a reclassification of amounts, depending on how they were reported in the fund financial statements.

Note Disclosures. GASBS No. 16 does not require any disclosures about compensated absences. However, the accounting policy for compensated absences typically is disclosed when the liability is separately reported. Also, GASBS No. 38, paragraph 13, requires governments to provide details in the notes to the financial statements when significant components of payables have been obscured by aggregation in the balance sheet/statement of net assets.

On-behalf Payments. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, establishes accounting and reporting standards for on-behalf payments for fringe benefits and salaries. The following summarizes the requirements of Statement No. 24 related to on-behalf payments:

- Employer governments should recognize revenue equal to the amounts that third-party recipients received plus the amounts that are receivable by the third-party at the fiscal year end of the employer government.

- If the employer government is not legally responsible for the payment of salaries or fringe benefits, it should recognize expenditures or expense equal to the amount recognized as revenue.

- If the employer government is legally responsible for the payment of salaries or fringe benefits, the governmental unit should follow accounting standards for that type of transaction to recognize expenditures or expense (i.e., follow standards related to employer accounting for pension benefits related to on-behalf payments to a pension plan).

GASB Statement No. 24 does not require the employer government to allocate on-behalf payments to individual funds. However, the employer government may allocate revenues and expenditures or expenses related to on-behalf payments based on the salaries charged to individual funds. If on-behalf payments are recognized in only one fund, that fund is usually the general fund, unless the payments relate entirely to another fund-type, such as an enterprise fund.

Statement No. 24, paragraph 12, requires employers to disclose in the notes to financial statements the amounts recognized for on-behalf payments for fringe payments and salaries. In addition, if the employer government is not legally responsible for on-behalf payments to a pension plan, the employer government should disclose the name of the plan that covers its employees and the name of the entity that makes the contributions.

SELF-STUDY QUIZ

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

32. Which of the following assertions relevant to payroll is the existence or occurrence assertion?

    a. The payroll amount and any related payroll tax liability is correctly recorded for each payroll period.

    b. All payroll expenditure transactions that should be recorded in the financial statements are actually in the financial statements.

    c. Payroll is computed using rates and other factors in accordance with relevant regulations.

    d. Payroll disbursements are made only for work authorized and performed.

33. Lu Newby, staff auditor, is looking over the audit steps for all the areas she is assigned to complete. Lu decides that the audit steps for payroll and related liabilities are very similar to which of the following audit areas?

    a. Cash.

    b. Investments.

    c. Receivables.

    d. Accounts payable.

34. During the audit of the City of Ayedoneaux, the auditor is informed of the following conditions: There is a different system for salaried and hourly employees, the workforce is stable and there are no union employees. Based on this information, what area is the auditor currently reviewing so that the audit program can be developed?

    a. Payroll and related liabilities.

    b. Cash.

    c. Investments.

    d. Receivables.

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.)**

32. Which of the following assertions relevant to payroll is the existence or occurrence assertion? **(Page 340)**

    a. The payroll amount and any related payroll tax liability is correctly recorded for each payroll period. [This answer is incorrect. This is the audit assertion for the allocation/valuation of payroll.]

    b. All payroll expenditure transactions that should be recorded in the financial statements are actually in the financial statements. [This answer is incorrect. This is the audit assertion for completeness of payroll.]

    c. Payroll is computed using rates and other factors in accordance with relevant regulations. [This answer is incorrect. This is the audit assertion for rights/obligations of payroll.]

    d. Payroll disbursements are made only for work authorized and performed. [This answer is correct. It is important that the auditor verify that payroll disbursements are valid transactions.]

33. Lu Newby, staff auditor, is looking over the audit steps for all the areas she is assigned to complete. Lu decides that the audit steps for payroll and related liabilities are very similar to which of the following audit areas? **(Page 341)**

    a. Cash. [This answer is incorrect. The substantive audit procedures for cash focus primarily on making sure the bank reconciliation is reliable.]

    b. Investments. [This answer is incorrect. The substantive audit procedures for investments focus on the authorization for the investments, existence of the investments and proper valuation of the investments. The substantive audit procedures related to payroll focus much more on comparisons and ratios between the current and prior periods.]

    c. Receivables. [This answer is incorrect. The substantive audit procedures for receivables would include determining if the receivables exist and are accurate by confirming the amounts. Confirmation of the payroll amounts with employees generally is not a substantive audit procedure.]

    d. Accounts payable. [This answer is correct. The substantive audit procedures applied to accounts Payable are very similar to those used for payroll expenditures and related liabilities. This makes sense because many times a payable account is established for the remittance of payroll liabilities such as withholding tax.]

34. During the audit of the City of Ayedoneaux, the auditor is informed of the following conditions: There is a different system for salaried and hourly employees, the workforce is stable and there are no union employees. Based on this information, what area is the auditor currently reviewing so that the audit program can be developed? **(Page 341)**

    a. Payroll and related liabilities. [This answer is correct. All of the items listed in the scenario are relevant to developing the audit program for payroll.]

    b. Cash. [This answer is incorrect. If the auditor were developing the audit program for cash, the auditor would be interested in the number of bank accounts and whether a primary account exists.]

    c. Investments. [This answer is incorrect. If the auditor were developing the audit program for investments, the auditor would be making inquiries concerning the establishment of an investment policy and how well the investments adhere to that policy.]

    d. Receivables. [This answer is incorrect. If the auditor were developing the audit program for receivables, the auditor would be making inquiries concerning the government unit's various sources of revenue such as taxes, licenses and permits.]

OPERATING ASSETS, DEBT, AND EQUITY

In these audit areas, the primary emphasis is on balance sheet accounts, and the audit approach is almost entirely substantive. Transaction testing is not totally ignored, but the tests are made in conjunction with examination of the related balance sheet accounts.

Inventories

Inventories of a governmental unit consist of materials and supplies used in operations. The considerations that influence the scope of audit work for inventories include the accounting treatment of inventories (purchase or consumption method); the number of physical sites for storage and significance of inventories at each site; safeguarding measures used at each site (storekeepers have no incompatible duties, locked storage areas, established procedures for issuance from storage); and effectiveness of counting and pricing procedures.

Relevant Assertions for Inventories. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for inventories are as follows:

- Existence or occurrence (E/O)—Inventories reported in the financial statements physically exist and represent materials and supplies held for use in the normal course of the entity's operations.
- Completeness (C)—Inventories reported in the financial statements represent a complete listing of materials and supplies.
- Rights or obligations (R/O)—The entity has legal title to the inventories reported in the financial statements.
- Valuation or allocation (V)—Inventory listings are accurately priced, extended, footed, and summarized, and the totals are properly recorded in the accounts by fund type.
- Accuracy or classification (A/CL)—Inventories are properly classified in the financial statements. Information on inventories required by GAAP is fairly disclosed and at appropriate amounts.
- Cutoff (CO)—Inventories are recorded in the proper accounting period.

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

Substantive Audit Procedures for Inventories. Many of the auditor's substantive procedures for inventories are focused on obtaining audit evidence related to the existence and valuation assertions. Examples of substantive procedures at the account balance level for inventories are as follows:

- Compare the dollar amount of inventory by fund to prior periods and consider reasonableness in relation to knowledge of activity during the period.
- Consider the need to count inventory items and compare your counts to the client's counts.
- Inquire about the individual funds that have recorded inventory and the accounting method used by each of those funds to record inventory.
- Determine whether inventory amounts reported in the financial statements are properly classified, whether disclosures are adequate, and whether reservation of fund balance has been made, if necessary.

Audit Program for Inventories. A core audit program presents basic and extended substantive audit procedures for inventories. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for inventories that are normally adequate to respond to a set of underlying risk assessments considered typical of many governments.

Analytical Procedures and Audit Efficiency. It is important to carefully consider the audit risk and materiality associated with inventories before concluding that tests of details (i.e., counting and pricing) are necessary. Often, an analytical procedure that produces persuasive evidence may be sufficient. The auditor might compare the dollar amount of inventory by fund to prior periods and consider reasonableness in relation to knowledge of acquisitions and activity during the period. If inventories are less than tolerable misstatement for the fund type, fund, or opinion unit, the analytical comparison to prior periods shows no significant fluctuations, safeguarding controls appear adequate, and personnel conducting the physical inventory seem diligent and competent, test counts may be omitted or limited to a few items.

To achieve audit efficiency, it is also important to challenge the need to apply traditional procedures. Inventory is often well below tolerable misstatement for the fund type, fund, or opinion unit. Thus, it is usually a good candidate for omission of detailed audit procedures. If the controls are reasonable, the auditor may analytically test inventory by comparison of the balance to prior periods in light of the level of activity in the current period. Only if the inventory balance seems unreasonable would additional procedures be necessary.

Accounting Considerations. Governmental units may use either the "consumption" or the "purchase" method of recording inventory. Consumption method means that acquisition of materials and supplies is recorded initially in inventory accounts and charged as an expenditure when used. Purchase method means that materials and supplies are charged as expenditures when acquired, and inventory on hand at the end of the period is recorded as an asset (debit), and a reservation of the fund balance is required. Reservation of the fund balance is required for the purchase method, but not required for the consumption method unless a minimum amount of inventory has been identified as necessary.

Either the consumption or purchase method may be used in the governmental fund financial statements. However, only the consumption method may be used in the government-wide, proprietary fund, and fiduciary fund financial statements. (However, inventories that are reported on the purchase method are often not material to the government-wide financial statements and therefore need not be reported.)

SELF-STUDY QUIZ

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

35. Which of the following is **not** a relevant assertion for the audit of inventories?

    a. Inventories have been recorded appropriately and in the proper account.

    b. Inventories have been properly reflected in the financial statements.

    c. The amount reflected in the financial statements is computed using rates and other factors in accordance with contracts and relevant laws and regulations.

    d. Inventories reported represent amounts relating to the period and entity.

36. In which of the following scenarios does the auditor use the proper substantive procedure for the audit of inventories?

    a. Condalisa Wong is auditing the inventories for the City of Morning Star. She makes inquiries of responsible officials about how Morning Star raises revenue.

    b. George Steplightly is auditing the inventories for the City of Lake Worth. He determines an inventory count will be necessary.

    c. Bob Goff is auditing the inventories for Winfield Township. He determines that unrealized gains and losses are appropriately valued and properly classified.

    d. Carol Boughlini is auditing the inventories for the Town of Menard. She makes inquiries of responsible parties about their knowledge of unprocessed invoices.

37. Alfred Euclid, audit manager for the audit of the City of Hasseldom, is looking at the inventory of plants and shrubs maintained in the city nursery. Alfred observes that the controls over the shrubs are reasonable and the value of the inventory is below the tolerable misstatement for the opinion unit. Alfred has decided to omit a physical count of the plants and shrubs from the audit procedures. Select the alternative procedures Alfred may use to satisfy the audit program steps for the inventory of plants and shrubs held by the City of Hasseldom.

    a. There are no alternative procedures for auditing inventory other than a physical count.

    b. Alfred might compare the dollar value of inventory between the current and prior periods and consider activity during the period.

    c. Alfred should confirm the delivery of plants and shrubs with the various vendors to determine if any fraud is present.

38. Alfred Euclid, audit manager for the audit of the Town of Twin Pines, is looking at inventories for the government-wide financial statements. He notices that some inventories, which are not material, have been recorded under the purchase method. What does this accounting method for inventories mean to Alfred's audit report?

    a. An adjusting entry must be made to get the inventory balances back on the books.

    b. Alfred must modify his opinion as accounting for inventories using the purchase method is not permitted by GASB.

    c. The inventories are not material to the government-wide financial statements and will not be included in the end product of Alfred's audit.

    d. Alfred should request that the government entity restate the inventory balance using the consumption method.

SELF-STUDY ANSWERS

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

35. Which of the following is **not** a relevant assertion for the audit of inventories? **(Page 349)**

    a. Inventories have been recorded appropriately and in the proper account. [This answer is incorrect. This answer choice properly reflects the classification assertion for inventory.]

    b. Inventories have been properly reflected in the financial statements. [This answer is incorrect. This answer choice properly reflects the rights assertion for inventory.]

    c. The amount reflected in the financial statements is computed using rates and other factors in accordance with contracts and relevant laws and regulations. [This answer is correct. This answer choice reflects the rights and obligations assertion for payroll.]

    d. Inventories reported represent amounts relating to the period and entity. [This answer is incorrect. This answer choice properly reflects the existence assertion for inventory.]

36. In which of the following scenarios does the auditor use the proper substantive procedure for the audit of inventories? **(Page 349)**

    a. Condalisa Wong is auditing the inventories for the City of Morning Star. She makes inquiries of responsible officials about how Morning Star raises revenue. [This answer is incorrect. Condalisa has performed a substantive audit procedure for the audit of revenue.]

    b. George Steplightly is auditing the inventories for the City of Lake Worth. He determines an inventory count will be necessary. [This answer is correct. George's inventory count will reveal any discrepancies between the count and the governmental unit's recorded inventory.]

    c. Bob Goff is auditing the inventories for Winfield Township. He determines that unrealized gains and losses are appropriately valued and properly classified. [This answer is incorrect. Bob has performed a substantive audit procedure for investments.]

    d. Carol Boughlini is auditing the inventories for the Town of Menard. She makes inquiries of responsible parties about their knowledge of unprocessed invoices. [This answer is incorrect. Carol has performed a substantive audit procedure for payables.]

37. Alfred Euclid, audit manager for the audit of the City of Hasseldom, is looking at the inventory of plants and shrubs maintained in the city nursery. Alfred observes that the controls over the shrubs are reasonable and the value of the inventory is below the tolerable misstatement for the opinion unit. Alfred has decided to omit a physical count of the plants and shrubs from the audit procedures. Select the alternative procedures Alfred may use to satisfy the audit program steps for the inventory of plants and shrubs held by the City of Hasseldom. **(Page 350)**

    a. There are no alternative procedures for auditing inventory other than a physical count. [This answer is incorrect. To achieve audit efficiency, the auditor should consider the materiality and audit risk prior to proceeding with a physical inventory count.]

    b. Alfred might compare the dollar value of inventory between the current and prior periods and consider activity during the period. [This answer is correct. Analytical procedures that produce adequate audit evidence may be sufficient, especially if other conditions, such as the competence of the individuals conducting the physical inventory are present.]

    c. Alfred should confirm the delivery of plants and shrubs with the various vendors to determine if any fraud is present. [This answer is incorrect. The facts of the scenario do not represent that Alfred has been engaged to uncover suspected fraud in the city nursery. In addition, confirmation of accounts is an audit procedure usually reserved for cash and accounts receivable.]

38. Alfred Euclid, audit manager for the audit of the Town of Twin Pines, is looking at inventories for the government-wide financial statements. He notices that some inventories, which are not material, have been recorded under the purchase method. What does this accounting method for inventories mean to Alfred's audit report? **(Page 350)**

    a. An adjusting entry must be made to get the inventory balances back on the books. [This answer is incorrect. An adjusting entry to record the inventories is the appropriate method to report inventories accounted for under the purchases method, however, since the inventories are not material an adjusting entry in this case is not required.]

    b. Alfred must modify his opinion as accounting for inventories using the purchase method is not permitted by GASB. [This answer is incorrect. The purchase method is permitted by GASB.]

    c. The inventories are not material to the government-wide financial statements and will not be included in the end product of Alfred's audit. [This answer is correct. The consumption method is the only method permitted for government-wide, proprietary fund, and fiduciary fund financial statements unless the inventories reported using the purchase method are immaterial.]

    d. Alfred should request that the government entity restate the inventory balance using the consumption method. [This answer is incorrect. In this instance the GASB standards do not require the governmental entity to use any one particular inventory valuation method.]

Capital Assets and Expenditures

Unique Considerations for Auditing Capital Assets and Expenditures of a Governmental Unit. Governments obtain property and equipment in the same manner as most private-sector business enterprises and nonprofit organizations. Capital assets may be acquired by purchase, construction, lease, donation, or foreclosure. Some intangible assets may be internally generated (i.e., computer software). The method of acquisition may dictate the valuation of, or accounting for, an asset. For example, a donated vehicle would be reported at its fair value at the time of donation. A leased vehicle would be reported as an asset at the net present value of required payments under a capital lease and would not be reported as an asset of the government under an operating lease.

GASBS No. 34 states that capital assets include land, land improvements, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.

GASBS No. 51, *Accounting and Financial Reporting for Intangible Assets*, provides additional guidance on intangible assets. It indicates that intangible assets are those which lack physical substance, are nonfinancial in nature, and have useful lives extending beyond a single reporting period. However, goodwill, assets obtained through capital leases, and assets that are used to obtain income or generate profit are excluded from the scope of GASBS No. 51. The Statement clarifies that all intangible assets included in its scope should be classified as capital assets. All existing GAAP on capital assets—for recognition, measurement, depreciation (called amortization in this case), and disclosure—apply to intangible assets. GASBS No. 51 is applicable to financial statements for periods beginning after June 15, 2009, with earlier application encouraged.

Compliance Requirements. Legal and contractual requirements often dictate terms for acquisition and disposal of capital assets. For example, acquisitions generally require budgetary authorization and governing board approval. Also, legal provisions often stipulate procedures for bidding and awarding contracts. Other legal restrictions may require the government to dispose of assets that are no longer used either by selling them at auction or by donating them to other governments or not-for-profit organizations. If the asset was financed through a bond issue, there may be debt covenant compliance requirements. If the asset was funded entirely, or in part, by intergovernmental revenues or donations from nongovernmental entities, there may be compliance requirements that relate not only to the acquisition and disposition of capital assets but also to maintenance and recordkeeping. GAAS establish the auditor's responsibility for compliance at the level of compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

Relevant Assertions for Capital Assets and Expenditures. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for capital assets and expenditures are as follows:

- Existence or occurrence (E/O)—Reported capital assets represent items owned or otherwise required to be reported (such as capital assets acquired through capital lease), considering the governmental unit's capitalization policies, as of the end of the period. Reported capital expenditures and depreciation/amortization represent amounts relating to the period and pertain to the entity. Disclosed capital assets, accumulated depreciation/amortization, capital expenditures, and depreciation/amortization expense have occurred and pertain to the government.

- Completeness (C)—Expenditures and depreciation/amortization expense related to the period and all capital assets and accumulated depreciation/amortization as of the end of the period have been reported. All required disclosures have been included in the financial statements.

- Rights or obligations (R/O)—Conditions and agreements that affect the entity's rights and obligations concerning capital assets have been properly reflected in the financial statements.

- Valuation or allocation (V)—Capital assets and accumulated depreciation/amortization are reported at the proper amounts. Information pertaining to capital assets is disclosed at appropriate amounts.

- Accuracy or classification (A/CL)—Amounts and data pertaining to capital expenditures and depreciation/amortization expense have been recorded appropriately and in the proper accounts. The financial statements properly classify, describe, and disclose the activity and balances relating to capital assets, including classification in the proper fund and activity. Financial information for capital assets, accumulated depreciation/amortization, capital expenditures, and depreciation/amortization expense is disclosed fairly and at appropriate amounts in accordance with GAAP. Disclosures are clearly expressed.

- Cutoff (CO)—Capital expenditures have been recorded in the correct accounting period.

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

Substantive Audit Procedures for Capital Assets and Expenditures. Transactions that affect capital assets usually involve high dollar amounts but are relatively few in number. In addition, because of their cost and significance to most entities, capital asset expenditures generally are carefully monitored by management and controlled by budget appropriation. Accordingly, auditors often assess the risk of material misstatement related to property as low. (In contrast, transactions that involve a high degree of judgment and subjectivity, amounts derived from accounting estimates, and unusual or complex transactions have a higher risk of material misstatement.)

Because capital assets generally are material, auditors are required to design and perform substantive procedures for all relevant assertions related to capital assets. However, when the risk of material misstatement is low, substantive analytical procedures generally provide the auditor with sufficient appropriate audit evidence for relevant assertions related to capital assets and expenditures. Tests of details, such as (a) vouching additions, retirements, and maintenance accounts, and (b) recalculating depreciation, are not necessary. In addition, because auditors generally will have audited the capital assets accounts in prior years, current-period substantive procedures can focus primarily on additions and dispositions during the year. SAS No. 110 (AU 318.64) states that auditors may use audit evidence obtained from the performance of substantive procedures in a prior audit if they perform audit procedures in the current period to establish the continuing relevance of the prior audit evidence. With respect to capital assets, auditors generally can establish the continuing relevance of audit evidence obtained in prior years that substantiates the beginning balance, such as the purchase cost of a building or building addition, by making inquiries, supplemented by observation and inspection, and considering whether the property is fundamentally the same as in the prior year.

The auditor obtains evidence for capital assets and expenditures primarily through reviewing governing body minutes, statutes and regulations, grant agreements and donor letters, contracts to lease or sell capital assets, and other supporting documents; inquiring of management and others; and performing analytical procedures to obtain evidence about the following matters:

- Whether the governmental unit is in compliance (during the year and at year-end) with compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

- Whether the governmental unit has satisfactory title to capital assets or other evidence supporting the reporting of infrastructure assets, whether any liens exist, and whether any capital assets have been pledged.

- Whether depreciation expense has been properly charged to the various functions.

- Whether the value of donated capital assets has been properly recorded.

- Whether capital asset impairments have been properly reported.

- Whether interfund transfers of capital assets and related debt have been properly reported.

- Whether the asset management system and documentation of the condition of assets comply with the standards in GASBS No. 34, if the modified approach is used for infrastructure assets.

- Whether financial statement disclosures for capital assets and related accounts are in conformity with GAAP.

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

- Compare balances in the capital assets and accumulated depreciation/amortization accounts with balances for prior years and the capital budget or other auditor-developed expectations. Investigate any unexpected results.

- Inquire of the client if all additions and deletions have been reflected in the capital assets schedule and relate such responses to capital expenditures and significant lease payments as well as to significant sales of capital assets.

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

- Scan the capital assets schedule and consider whether the lives of assets are reasonable, whether depreciation/amortization methods are in accordance with GAAP and consistent, and whether depreciation expense for the year appears reasonable. Determine whether capital asset impairments have been properly reported.

The following procedures performed during other aspects of the audit also contribute to audit evidence for capital assets and expenditures:

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

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

Audit Program for Capital Assets and Expenditures. A core audit program presents basic, extended, and additional substantive audit procedures for capital assets and expenditures. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for capital assets and expenditures that are normally adequate to respond to a set of underlying risk assessments considered typical of many smaller governments.

In considering the nature and extent of audit procedures necessary for capital assets and expenditures, the auditor might inquire about matters such as the following: What are the nature and extent of self-construction by the governmental unit? What are the nature and extent of leasing of buildings or equipment? Are capital budgets used? Is a work order control system used? What loan covenant or grant program restrictions are there on additions to property and equipment? What regulatory requirements (e.g., OSHA, EPA, etc.) are applicable? Historically, what have been the nature and extent of asset additions and disposals?

Accounting Considerations. Governmental activities in the government-wide financial statements are reported using the accrual basis of accounting—the same basis of accounting used by proprietary funds. As a result, capital acquisitions are presented as capital assets rather than capital expenditures. In addition, depreciation/amortization must be recorded for all governmental capital assets, excluding inexhaustible assets such as land and land improvements and infrastructure reported under the modified approach. All governments must report general infrastructure assets prospectively and certain governments (as determined by size) must report major general infrastructure assets retroactively.

General capital assets, including infrastructure assets and certain intangible assets, should be recorded at historical cost, including ancillary charges. Donated assets, including intangible assets, should be recorded at estimated fair value at time of acquisition. Only those major general infrastructure assets purchased, constructed, donated, or renovated (major) in fiscal years ending after June 30, 1980 must be included. If historical cost amounts are not available due to inadequate records, historical cost may be estimated. The historical cost of major general infrastructure assets may be estimated by using capital project fund expenditures, bond documents, engineering documents, and information from other departments in the government. Alternatively, historical cost can be estimated by calculating the current replacement cost and deflating it to the date of acquisition using price-level indexes.

Donated Capital Assets. The fund-level accounting for donated capital assets depends on whether the fund is a proprietary fund or a governmental fund. For proprietary funds, donated capital assets are reported as revenues, capitalized, and depreciated. For governmental funds, when a government receives a donated asset that it intends to use as a general capital asset, no entry is required because no financial resource flow has taken place. However, if the government intends to liquidate the donated capital asset, the asset would be reported in a governmental fund. Best practices indicate that the auditor obtain evidence that the government's intent is supported by a contract for sale prior to issuance of the financial statements. Otherwise, the donated asset should be treated like a capital asset that is used in operations until a sale occurs.

Internally Generated Intangible Assets. Capitalization of the costs of internally generated intangible assets is limited. An intangible asset is internally generated if the asset is either:

a. Created or produced by the government's personnel or by a third party contractor on behalf of the government, or

b. Acquired from a third party but the government must make more than a minimal effort to modify the asset so that it achieves its expected level of service capacity.

The costs of a project to create an internally generated asset should be capitalized only once the government has been able to meet all of these three milestones:

a. The government determines the specific objective of the project and the nature of the service capacity that it expects the project to provide once it is completed.

b. The government is able to demonstrate the technical or technological feasibility of completing the project with the capacity planned in item a.

c. The government demonstrates the current intention, ability, and presence of effort to complete or, for larger or multi-year projects, continue developing the intangible asset.

Any costs incurred before these three milestones have been met should be expensed when incurred.

Pollution Remediation Activities. Most pollution remediation outlays for property, plant, and equipment should be reported as expenses, not capital assets, in the government-wide and proprietary fund financial statements.

However, governments should capitalize remediation costs in the government-wide and proprietary fund statements when the costs were incurred to:

- Prepare property in anticipation of a sale (but, only if the outlays take place in a reasonable time before the sale).
- Prepare property for use when that property was acquired with known or suspected pollution that the government expected to remediate.
- Perform remediation to restore a pollution-caused decline in service utility that the government has reported or will report as an impairment of one of its capital assets.
- Acquire property, plant, or equipment that can be used for other purposes after the remediation activities are complete.

Accounting System Considerations. Detailed asset ledgers should be maintained and periodically reconciled to general ledger control accounts. Also, a permanent file should be maintained in a central location of all leases, including lease-purchase agreements. Detailed ledgers should be periodically reconciled to a physical inspection of assets.

Some governmental units have not maintained or reconstructed detailed records of their capital assets, especially older assets. In this situation, the accounting records might not provide sufficient audit evidence to support the assertions for capital asset accounts. It could be particularly difficult to obtain persuasive support related to calculating depreciation/amortization expense, recording and reporting dispositions, and allocating depreciation/amortization expense to functions.

GASBS No. 34 requires certain disclosures about capital assets to be divided into major classes of capital assets. It allows for certain inexhaustible assets to be accounted for using a modified approach and thus not be depreciated. If the accounting records do not separately identify major classes of capital assets or nondepreciable capital assets, the governmental unit either cannot conform with or cannot provide support for its conformity with those requirements.

The auditor should use professional judgment in evaluating whether and to what extent the lack or insufficiency of detailed capital assets records affects the report on the financial statements. Factors the auditor might consider in this evaluation include (a) the significance of the capital assets for which detailed records do not exist compared to those for which the records do exist, (b) the existence of other audit evidence to support the applicable assertions, and (c) the materiality of the capital assets and related accounts to the opinion unit in which they are reported. The auditor also should consider whether the lack of records is a significant deficiency, and possibly a material weakness, in internal control that must be communicated to management and those charged with governance.

Relation to Transaction Tests of Expenditures. The results of testing expenditure transactions influence the scope of work on capital asset additions. The additions to capital assets selected for vouching are usually based on a cutoff amount for individually significant items. All additions above the cutoff amount are vouched.

If additions to capital assets are processed by a different system than is used for purchases of goods and services, the auditor should consider expanding the number of individual acquisitions tested by lowering the cutoff amount for individually significant items. If there is a large volume of capital expenditures and sampling is considered necessary, the auditor could select a sample of additions (concurrently with cash disbursements) and review for account distribution, agreement of recorded amount with supporting documents, and proper period. Since the purpose of sampling in this case is to substantiate the validity of capital assets and expenditures, the appropriate sampling approach is that for substantive tests of balances or transactions.

Analytical Procedures for Depreciation/Amortization. The auditor should test the adequacy and reasonableness of current year depreciation/amortization by performing analytical procedures, if practical. A predictive test based on prior year methods and ratios may be very effective. If there are significant fluctuations, the auditor should recompute depreciation/amortization expense on selected assets.

Impairment of Capital Assets. GASBS No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, requires governments to report an impairment loss when the service utility of a capital asset declines significantly and unexpectedly. Paragraph 8 of GASBS No. 42 notes that the events and changes in circumstances indicating potential impairment are prominent, conspicuous, and known to the government. Additionally, these events or changes generally would have prompted discussion by the governing board, management, or the media. Paragraph 9 of GASBS No. 42 lists several examples of "common indicators" that an asset may have been impaired:

- Evidence of physical damage, for example, by fire or flood.
- A change in legal requirements or environmental factors that govern the asset's use, for example, enactment of new water quality standards that cannot be met by an existing water treatment plant.
- Technological changes or evidence of obsolescence, for example, an asset that is no longer used because a newer model is more efficient.
- A change in the way an asset is used or in the length of time it was expected to be used, for example, a piece of equipment used in a utility plant that is being closed before the end of its useful life.
- Construction stoppage, for example, when construction is halted due to lack of funds.

If a capital asset has been identified as being *potentially* impaired, GASBS No. 42 requires the government to determine if the two impairment tests in the standard have been met—both of which must be met—before an impairment loss is required to be reported. If both impairment tests are met and the government expects to continue to use the asset, impairment is required to be measured in one of three ways, depending on the nature of the impairment.

Write-offs should be reported as program expense (or nonoperating revenue in enterprise fund operating statements), or extraordinary or special items in the government-wide statement of activities or enterprise fund operating statement. If the amount of the impairment and its financial statement classification are not apparent from the face of the financial statements, both should be disclosed in the notes. (Because there are no financial resource flows, no write-offs would be reported in a governmental fund operating statement.)

In the government-wide and enterprise funds statements, insurance recoveries occurring in the same fiscal year as the write-off should be netted against the related loss. Insurance recoveries that occur after the year the asset is written down should be reported in the same manner as the write-off—as a program revenue (or nonoperating revenue in an enterprise fund), special item, or extraordinary item. Insurance recoveries in governmental funds should be reported as "other financing sources" or as extraordinary or special items.

SELF-STUDY QUIZ

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

39. Which of the following assertions are relevant to the audit of capital assets and expenditures?

    i. Reported capital assets represent items owned.

    ii. Capital assets are items required to be reported.

    iii. Amounts and data pertaining to capital expenditures are at appropriate amounts.

    iv. Debt secured by a capital asset exists.

    a. i only.

    b. ii and iv.

    c. i and ii only.

    d. i, ii, and iii.

40. Alfred Euclid, Audit Manager and Lu Newby, staff auditor, are discussing the substantive audit procedures for capital assets and expenditures. Alfred asks Lu to obtain the details of the results of the prior year audit of capital assets and expenditures. Which of the following answer choices best describes why Alfred is interested in the results of the prior-year audit?

    a. SAS No. 110 states that auditors may use audit evidence obtained from a prior audit.

    b. The transactions that affect capital expenditures are usually high-dollar amounts and few in number.

    c. Capital asset expenditures usually are controlled by budgets and carefully monitored by management.

    d. The risk of material misstatement related to capital assets is low.

41. Lu Newby, staff auditor for the audit of the City of Petalsky, has learned that the city self-constructed many of the new buildings added to the books over the most recent year. Conceptually, what should Lu be concerned with next?

    a. Whether the city has met regulatory requirements such as OSHA.

    b. Whether employees on the construction site are salaried or hourly.

    c. The GASB 34 reporting considerations for the construction fund.

    d. The source of government revenues used to fund the construction projects.

42. How are capital acquisitions presented in a government-wide financial statement?

    a. Capital expenditures.

    b. Capital assets.

    c. Capital expenditures if expenditure is for infrastructure.

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.)**

39. Which of the following assertions are relevant to the audit of capital assets and expenditures? **(Page 354)**

    i. Reported capital assets represent items owned.

    ii. Capital assets are items required to be reported.

    iii. Amounts and data pertaining to capital expenditures are at appropriate amounts.

    iv. Debt secured by a capital asset exist.

    a. i only. [This answer is incorrect. This answer choice reflects one aspect of the assertions relevant to the audit of capital assets and expenditures. There is better answer choice.]

    b. ii and iv. [This answer is incorrect. This answer choice reflects one aspect of the assertions relevant to the audit of capital assets and expenditures. There is better answer choice.]

    c. i and ii only. [This answer is incorrect. This answer choice reflects two aspects of the assertions relevant to the audit of capital assets and expenditures. There is better answer choice.]

    d. i, ii, and iii. [This answer is correct. According to the audit standards, all three of the assertions presented are relevant to the audit of capital assets and expenditures.]

40. Alfred Euclid, Audit Manager and Lu Newby, staff auditor, are discussing the substantive audit procedures for capital assets and expenditures. Alfred asks Lu to obtain the details of the results of the prior year audit of capital assets and expenditures. Which of the following answer choices best describes why Alfred is interested in the results of the prior-year audit? **(Page 355)**

    a. SAS No. 110 states that auditors may use audit evidence obtained from a prior audit. [This answer is correct. Auditors may use audit evidence obtained in a prior audit when attempting to establish the continuing relevance of prior audit evidence in the current audit.]

    b. The transactions that affect capital expenditures are usually high-dollar amounts and few in number. [This answer is incorrect. The answer choice reflects a trait of capital expenditure transactions, however, this is not the reason the audit manager is interested in the results of the prior year audit.]

    c. Capital asset expenditures usually are controlled by budgets and carefully monitored by management. [This answer is incorrect. While it is true that capital asset expenditures for a local government are carefully budgeted and monitored by management, this is not the reason why the audit manager is interested in the results of the prior year audit. There is a better answer choice.]

    d. The risk of material misstatement related to capital assets is low. [This answer is incorrect. Due to the careful budgeting and monitoring of those charged with governance, the risk of misstatement of capital asset expenditures is low. However, this answer choice does not supply the reason why the audit manager is interested in the results of the prior year audit.]

41. Lu Newby, staff auditor for the audit of the City of Petalsky, has learned that the city self-constructed many of the new buildings added to the books over the most recent year. Conceptually, what should Lu be concerned with next? **(Page 356)**

    a. Whether the city has met regulatory requirements such as OSHA. [This answer is correct. Since the City of Petalsky is self-constructing buildings, Lu should add audit program steps to cover the liabilities a construction contractor might face. This would include OSHA and EPA regulations.]

    b. Whether employees on the construction site are salaried or hourly. [This answer is incorrect. This answer choice reflects an audit program consideration for the audit of payroll. Certainly the construction workers on the city's payroll will be included in population selected for audit procedures performed for the audit of payroll.]

    c. The GASB 34 reporting considerations for the construction fund. [This answer is incorrect. This answer choice reflects a more general audit program step and is therefore not the best answer choice.]

    d. The source of government revenues used to fund the construction projects. [This answer is incorrect. This answer choice reflects the audit program consideration for the audit of revenues and receivables.]

42. How are capital acquisitions presented in a government-wide financial statement? **(Page 356)**

    a. Capital expenditures. [This answer is incorrect. Government-wide financial statements are reported using the accrual basis of accounting. This is the same accounting basis used by proprietary funds.]

    b. Capital assets. [This answer is correct. The accrual basis of accounting requires that government-wide financial statements present capital acquisitions as capital assets.]

    c. Capital expenditures if expenditure is for infrastructure. [This answer is incorrect. Under GASBS No. 34, all governments must report general infrastructure assets prospectively as capital assets.]

Debt and Debt Service Expenditures

Relevant Assertions for Debt and Debt Service Expenditures. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for debt and debt service expenditures are as follows:

- Existence or occurrence (E/O)—Debt reflected in the financial statements exists and is properly authorized.
- Completeness (C)—All indebtedness of the governmental unit is identified, recorded, and disclosed.
- Rights or obligations (R/O)—Debt reflected in the accounts is the obligation of the entity. The governmental unit has complied with provisions of indentures and agreements related to debt, including provisions on use of proceeds.
- Valuation or allocation (V)—Debt is valued in accordance with GAAP.
- Accuracy or classification (A/CL)—Debt service expenditures (principal and interest payable) are properly recorded, classified, and disclosed. Debt and related restrictions, guarantees, and commitments are properly presented in the financial statements. Information about debt and debt service expenditures required by GAAP is fairly disclosed and at appropriate amounts.
- Cutoff (CO)—Debt and debt service expenditures are recorded in the proper accounting period.

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

Substantive Audit Procedures for Debt and Debt Service Expenditures. The auditor obtains evidence for debt and debt service expenditures primarily through reviewing governing body minutes, debt agreements, and other supporting documents; inquiring of management and others; and performing analytical procedures to obtain evidence about the following matters:

- Whether the governmental unit is in compliance (during the year and at year-end) with compliance requirements that could have a direct and material effect on the determination of financial statement amounts.
- Whether governmental unit's debt issuances are measured, presented, and disclosed in the financial statements in conformity with GAAP.

The audit of debt and debt service expenditures concentrates primarily on the financial statement assertions of completeness, cutoff, and the presentation and disclosure assertions of accuracy/classification. The other assertions—existence/occurrence, rights/obligations, and valuation—are addressed within the audit procedures designed to test the primary assertions. Examples of substantive procedures for debt and debt service expenditures include:

- Compare balances of debt and related interest expense accounts with those of prior years and investigate any unexpected results.
- Review documentation for debt coverage and determine whether taxes levied or other revenues dedicated to service the debt are adequate.
- Review minutes or other appropriate documents (such as bond referendums) approving issuance of debt. Trace authorized debt to the accounting records and consider the appropriateness of classification.

- Inquire of the client about whether all debt has been recorded, identified, and disclosed. Compare balances to amounts confirmed on bank or other confirmations.

- Inquire of management about the existence of derivative financial instruments or securities lending agreements. If there are such agreements, determine that accounting and disclosure are in accordance with GAAP.

- Analytically test the reasonableness of interest cost and accrued interest.

- Review documentation supporting compliance with debt covenants or other restrictions. Re-perform tests to determine whether the governmental unit is in compliance with restrictive covenants.

Audit Program for Debt and Debt Service Expenditures. A core audit program presents basic, extended, and additional substantive audit procedures for debt and debt service expenditures. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for debt and debt service expenditures that are normally adequate to respond to a set of underlying risk assessments considered typical of many governments.

The nature and extent of audit procedures for debt and debt service expenditures are influenced by considerations such as the following: the nature and amount of the governmental unit's debt and similar obligations; how often and in what amounts the governmental unit issues debt or enters into debt agreements; the legal requirements for issuing debt or entering debt agreements; the identity of the trustees or fiscal agents used for debt; and the debt covenants or similar debt-related restrictions.

Audit Considerations. The auditor needs to obtain reasonable assurance that debt is authorized properly; that all indebtedness of the governmental unit is identified, recorded, and disclosed; and that the governmental unit has complied with provisions of indentures and agreements related to debt, including provisions on use of proceeds. Thus, the auditor's procedures are directed to determining whether debt is incurred but not authorized, debt is not recorded and proceeds misappropriated, debt or proceeds are misclassified (fund or account), there are violations of debt restrictions, or restricted funds have been used improperly. The audit procedures necessary to achieve these objectives are generally the same as those used for business enterprises and include confirmation with lending banks and other financial institutions. Normally, debt transactions are all material and all are examined.

Analytical Procedures and Debt Service Expenditures. The auditor is also concerned with obtaining reasonable assurance that debt service expenditures (principal and interest payments) are properly recorded, classified, and disclosed. Note that debt service expenditures are *payments on debt principal and interest*. For governmental fund financial statements, interest cost generally is recognized as an expenditure in the accounting period in which it is due (paid), rather than when it would be accrued, and debt service expenditures are recorded as expenditures in the fund that has been designated to make the payments, usually the debt service fund. Interest cost for proprietary fund debt is recognized on the accrual basis. For short-term debt and proprietary fund debt, payment is recorded in the fund in which the debt is recorded as a reduction of the recorded liability. For long-term debt, the current installment of principal is recorded as an expenditure and liability of the applicable fund servicing the debt.

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. Individually significant debt service expenditures can be selected for more detailed testing.

Accounting Considerations—Fund Financial Statements. The accounting treatment of debt in the governmental fund financial statements can be complex. Generally, the liability for outstanding short-term debt issued for the benefit of governmental funds is recorded as a liability in the balance sheet of the governmental fund receiving the proceeds. The liability for both short-term and long-term debt is recorded as a liability in a proprietary fund's balance sheet and the government-wide financial statements. In the fund financial statements, debt service (principal, interest, and other related costs) is accounted for and reported in the governmental or proprietary fund that is responsible for the repayment. Governmental funds frequently record long-term debt payments through a debt service fund. However, GAAP does not require use of a debt service fund unless bond indentures or local law require its use or resources are being accumulated for debt service payments in future years. Short-term governmental debt usually is repaid from the fund that received the proceeds. All proprietary fund debt repayment transactions are recorded in the individual fund in which the outstanding debt is recorded.

Accounting Considerations—Government-wide Financial Statements. All current and long-term governmental debt, including general long-term debt, and debt service is reported in the government-wide financial statements on the accrual basis of accounting in the same manner as that described in the preceding paragraph for proprietary funds. Typically, general long-term debt is reported in the governmental activities column.

Debt Refundings by Proprietary Activities. GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, provides accounting and financial reporting guidance for both current refundings and advance refundings resulting in defeasance of debt undertaken by proprietary funds and other governmental units that use proprietary fund accounting. Those refundings are the issuance of new debt undertaken to permit governmental units to take advantage of declines in interest rates by exchanging higher-cost bonds for lower-cost bonds.

Current refundings are transactions in which governmental units immediately repay outstanding debt with the proceeds of new debt. In an advance refunding, instead of repaying the outstanding debt immediately (generally because it is not yet callable), a governmental unit places the proceeds with an escrow agent who invests them in U.S. Government securities until they are used to pay principal and interest on the old debt at a future time.

GASBS No. 23 mandates that the difference between the reacquisition price and the net carrying amount of the old debt be deferred and amortized in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. Prior guidance for refundings required that such gains or losses be recognized at the time of the refunding, as required by commercial accounting. On the balance sheet, the deferred amount should be reported as a deduction from or an addition to the new debt liability.

SEC Debt Issuer Reporting Requirements. SEC Rule 15c2-12 requires issuers of municipal securities in aggregate principal amounts of $1 million or more to electronically report financial and operational information and notices of material events the Municipal Securities Rulemaking Board (MSRB). The information will be made publicly available through MSRB's Electronic Municipal Market Access (EMMA) system. (The SEC Rule can be downloaded at **www.law.uc.edu/CCL/34ActRls/rule15c2-12.html**.) In general, the following are significant requirements of the rule:

- The financial and operational information required to be reported annually is the same financial and operational information that was reported in the final official statement for the municipal securities issued. [A comprehensive annual financial report (CAFR) that contains the same financial and operating data as the issuer's final official statement should satisfy the annual financial information requirement.]
- If audited financial statements are prepared, they must be sent to the MSRB.
- Entities must report the following material events:
  - Principal and interest payment delinquencies.
  - Non-payment related default.
  - Unscheduled draws on debt service reserves reflecting financial difficulties.
  - Unscheduled draws on credit enhancements reflecting financial difficulties.
  - Substitution of credit or liquidity providers, or their failure to perform.
  - Adverse tax opinions or events affecting the tax-exempt status of the securities.
  - Modifications to rights of security holders.

- Bond calls.
- Defeasances.
- Release, substitution, or sale of property securing repayment of securities.
- Rating changes (either positive or negative).
- Failure to provide required annual financial information on or before the required date.

- In general, the rule exempts entities with less than $10,000,000 of aggregate municipal securities outstanding from the reporting requirements if they make a limited undertaking (i.e., a written agreement or contract) in which they have agreed to provide annual financial information, operating data, and material event notices to the MSRB. This requirement does not apply retroactively for those issuers that fall under the $10 million exemption and had contracts in place at July 1, 2009, that solely call for making financial information available to the public.
- Securities of offerings with a stated maturity of 18 months or less are exempt from the rule's annual financial reporting requirements, but not from the requirement to provide notices of material events.
- Primary offerings in denominations of $100,000 or more are exempt from reporting both annual financial information and material events if such securities (a) are sold to no more than 35 "sophisticated" investors, (b) have a maturity of nine months or less, or (c) may be tendered to the issuer for redemption or purchase at par value or more as often as every nine months.
- The definition of securities under the rule includes a variety of instruments in addition to bonds (such as, leases, notes, loans, installment sales agreements, and any other evidence of indebtedness).

The EMMA system will make the disclosures available to investors in the same manner that the SEC's EDGAR system does for corporate disclosures. EMMA will function as an online portal where investors can instantly access, for free, all of the key information produced by municipal bond issuers about their bonds. Offering documents, real-time trade prices, and education resources already are available on EMMA at **www.emma.msrb.org**.

Auditors are encouraged to test compliance with the SEC rule. Due to the complex nature of the reporting requirements, best practices indicate that auditors consult with the client's underwriters or bond counsel to determine the specific reporting requirements. In addition, auditors may want to modify the management representation letter to obtain management's representation that the governmental unit has complied with the SEC reporting requirements.

Conduit Debt Obligations. Conduit debt obligations, sometimes referred to as no-commitment debt, are limited-obligation revenue bonds or similar instruments issued by a governmental unit to provide capital financing for a third party (government or otherwise) that is not part of the reporting entity. Debt proceeds are typically used to finance development of industry, hospital, or environmental facilities within the governmental unit's jurisdiction that are transferred to the third party by sale or lease. The governmental unit has no obligation for the debt beyond the resources received from the third party.

GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations (an interpretation of NCGA Statement 1)* requires disclosure of the transaction, aggregate amount of outstanding obligations, and the issuer's obligation for the outstanding debt.

Arbitrage. The interest received by investors in local government debt securities issued to finance public facilities is not subject to federal taxes. Thus, investors are willing to accept a lower rate of interest on such securities than they would accept on comparable taxable securities. This condition enables governmental units to create arbitrage earnings from the debt proceeds before their expenditure on the intended purpose. Arbitrage is the excess income earned by the governmental unit from investing the proceeds of tax-exempt debt in higher yielding taxable securities.

Federal arbitrage regulation generally limit the rate of return on investment earnings of unexpended tax-exempt debt proceeds. With certain adjustments, the investment yield is limited to the interest rate on the debt issue itself.

Federal tax code requirements now require governmental units to rebate defined arbitrage earnings of tax-exempt debt to the federal government every five years for as long as the bonds are outstanding. Taxable debt is exempt from arbitrage rebate requirements.

Several exceptions to the rebate requirement are allowed by the federal tax code to reduce the administrative burden imposed by these regulations. These exceptions are explained in the instructions to IRS Form 8038-T, "Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate."

Best practices indicate that an arbitrage rebate liability should be recognized from investing the proceeds of tax-exempt debt in higher yielding taxable securities when incurred and measurable. Even though the rebate is not due to the federal government until the end of each five year period, it is recognized currently in the fund holding the bond proceeds because current resources (excess earnings) are available. The rebate calculation is performed on a cumulative basis at the end of each year. Therefore, arbitrage earnings in one year may be offset by lesser earnings in another year. The rebate may be recorded in a fund either as a reduction of interest income on the invested debt proceeds or as a separate charge in the operating statement, both with a corresponding fund liability.

The rules governing arbitrage on tax-exempt bonds and the calculation of the rebate are complex and confusing. In addition, the consequences of noncompliance can be severe, including taxing interest earnings of the governmental unit's bondholders. As a result, the authors recommend that auditors consult with knowledgeable professionals about their clients' compliance with the arbitrage rules and the calculation of the rebate liability. In addition, auditors may want to modify the management representation letter to obtain management's representation that the governmental unit has complied with the arbitrage regulations.

SELF-STUDY QUIZ

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

43. Lu Newby, staff auditor, is reviewing the debt as recorded in the financial statements for Porcelain Township. During the review, it is determined that the debt exists but has not been properly authorized. Potentially, what two audit assertions are violated under this set of circumstances?

    a. Valuation or allocation and cutoff.

    b. Existence or occurrence and valuation.

    c. Existence or occurrence and rights or obligations.

    d. Cutoff and rights or obligations.

44. Lu Newby, staff auditor, wants to test the reasonableness of interest cost and interest payable on the debt recorded in the financial statements of a governmental entity. Which of the following answer choices describes the best method for completing this audit procedure?

    a. Compute the ratio of depreciation expense to the related capital assets and compare to the ratio for prior years.

    b. Compare payroll expenditures to prior-period actual and current budget.

    c. Prepare an overall calculation based on the average principal amounts outstanding during the period and contractual interest rates.

45. Alfred Euclid, audit manager, has determined that the governmental entity under audit has not issued any debt since the completion of the field work of the prior year audit. How will this knowledge affect the audit program?

    a. Alfred may rely on the prior-year audit findings and perform substantive analytical procedures for the current year.

    b. Alfred will need to perform tests of details for the current year due to the high risk of material misstatement.

    c. Alfred will need to verify the debt was authorized by reviewing the minutes of the meeting authorizing the entity to take on additional debt.

    d. Alfred will need to expand the number of tests performed over those performed during the prior-year audit.

46. Alfred Euclid, audit manager, has discovered that his local government client incurred a current refunding to retire some old debt issuing new debt at a lower interest rate. What does this development mean to the reporting requirements of the local government?

    a. A footnote disclosure will be required to report the amount of net assets restricted by enabling legislation as of the end of the reporting period.

    b. Alfred may use audit evidence obtained from substantive procedures performed on the debt issued in a prior-year audit as long as Alfred also is able to establish the continuing relevance of the prior-year audit evidence.

    c. As required by commercial accounting, a government entity with a current refunding requires that any gain or loss for the difference between the net carrying amount of the old debt and the reacquisition price of the old debt be recognized at the time of the refunding.

    d. The difference between the net carrying amount of the old debt and the reacquisition price of the old debt be deferred and amortized using a rational and systematic manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.

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.)**

43. Lu Newby, staff auditor, is reviewing the debt as recorded in the financial statements for Porcelain Township. During the review, it is determined that the debt exists but has not been properly authorized. Potentially, what two audit assertions are violated under this set of circumstances? **(Page 364)**

    a. Valuation or allocation and cutoff. [This answer is incorrect. Unauthorized debt may be properly valued in accordance with GAAP.]

    b. Existence or occurrence and valuation. [This answer is incorrect. This answer choice reflects only one assertion that has been violated.]

    c. Existence or occurrence and rights or obligations. [This answer is correct. The existence or Occurrence assertion indicates the debt should be properly authorized and exists. It is possible that unauthorized debt may not be an obligation of the entity.]

    d. Cutoff and rights or obligations. [This answer is incorrect. It is possible that unauthorized debt is recorded in the proper accounting period according to the date of the expenditure.]

44. Lu Newby, staff auditor, wants to test the reasonableness of interest cost and interest payable on the debt recorded in the financial statements of a governmental entity. Which of the following answer choices describes the best method for completing this audit procedure? **(Page 365)**

    a. Compute the ratio of depreciation expense to the related capital assets and compare to the ratio for prior years. [This answer is incorrect. This audit step is related to capital expenditures rather than expenditures to service debt.]

    b. Compare payroll expenditures to prior-period actual and current budget. [This answer is incorrect. This audit step is related to payroll expenditures and would not reveal the reasonableness of interest expenditures.]

    c. Prepare an overall calculation based on the average principal amounts outstanding during the period and contractual interest rates. [This answer is correct. This answer choice properly outlines the audit step to perform to determine the reasonableness of the interest expenditure in the financial statements.]

45. Alfred Euclid, audit manager, has determined that the governmental entity under audit has not issued any debt since the completion of the field work of the prior-year audit. How will this knowledge affect the audit program? **(Page 365)**

    a. Alfred may rely on the prior year audit findings and perform substantive analytical procedures for the current year. [This answer is correct. Alfred may rely on the prior-year tests as the risk of material misstatement is low since no new debt has been issued.]

    b. Alfred will need to perform tests of details for the current year due to the high risk of material misstatement. [This answer is incorrect. The risk of material misstatement is low when no new debt has been issued.]

    c. Alfred will need to verify the debt was authorized by reviewing the minutes of the meeting authorizing the entity to take on additional debt. [This answer is incorrect. This answer choice reflects an audit step that would have been performed in the prior year. Since the debt was authorized in the prior year, it should still remain authorized for the current-year audit.]

    d. Alfred will need to expand the number of tests performed over those performed during the prior-year audit. [This answer is incorrect. Since no new debt has been issued, Alfred should be able to contract rather than expand the number of tests performed in the current-year audit.]

46. Alfred Euclid, audit manager, has discovered that his local government client incurred a current refunding to retire some old debt issuing new debt at a lower interest rate. What does this development mean to the reporting requirements of the local government? **(Page 366)**

  a. A footnote disclosure will be required to report the amount of net assets restricted by enabling legislation as of the end of the reporting period. [This answer is incorrect. Such disclosure is required by GASBS No. 46 when net assets are restricted by enabling legislation authorizing new resources and legally enforceable limits on how they may be used.]

  b. Alfred may use audit evidence obtained from substantive procedures performed on the debt issued in a prior-year audit as long as Alfred also is able to establish the continuing relevance of the prior-year audit evidence. [This answer is incorrect. While it is true auditors are able to rely on audit evidence obtained in the prior-year audit, it is unlikely in this scenario with the issuance of refunding debt that the prior-year audit evidence is relevant to the current year transaction.]

  c. As required by commercial accounting, a government entity with a current refunding requires that any gain or loss for the difference between the net carrying amount of the old debt and the reacquisition price of the old debt be recognized at the time of the refunding. [This answer is incorrect. This answer choice reflects the prior GASB guidance for refundings.]

  d. The difference between the net carrying amount of the old debt and the reacquisition price of the old debt be deferred and amortized using a rational and systematic manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. [This answer is correct. This answer choice reflects the GASBS No. 23 mandate for refundings.]

Equity and Financial Statement Reconciliations

Equities is a broad term used here to encompass all fund balances and net assets. Fund equity of a governmental fund is referred to as fund balance. Equity of proprietary fund types and financial statements in the government-wide financial statements consist of net assets as described later in this lesson.

Relevant Assertions for Fund Equities. Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. The relevant assertions of each opinion unit for fund equities are as follows:

- Existence or occurrence (E/O)—Reported changes in equity are based on actual transactions or other events relating to the period and pertain to the entity. Reported equity and its components are based on actual transactions or other events as of the end of the period. Disclosed equity events and transactions have occurred and pertain to the entity.

- Completeness (C)—All equity as of the end of the period and all changes in equity related to the period have been reported.

- Rights or obligations (R/O)—All required disclosures have been included in the financial statements. Conditions and agreements that affect the entity's rights and obligations concerning equity and its components have been properly reflected in the financial statements.

- Valuation or allocation (V)—Equity and its components are reported at the proper amounts. Information pertaining to equity and its components is disclosed at appropriate amounts.

- Accuracy or classification (A/CL)—Equity transactions and events have been recorded in the proper accounts. Amounts and other data relating to recorded equity transactions and events have been recorded appropriately. The financial statements properly classify, describe, and disclose equity and its components, including classification in the proper fund and activity. Financial information for equity is appropriately presented and described and disclosed fairly and at appropriate amounts in accordance with GAAP. Disclosures are clearly expressed.

- Cutoff (CO)—Equity transactions and events have been recorded in the correct accounting period.

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

Substantive Audit Procedures for Equity and Financial Statement Reconciliation. The auditor obtains evidence for equity and financial statement reconciliations primarily through reviewing (a) minutes, (b) the governmental unit's constitution, charter, statutes, and ordinances, (c) debt issuance documents, (d) contribution and grant agreements, and (e) other similar documents; inquiring of management and others; and performing other procedures to obtain evidence about the following matters:

- Whether the governmental unit is in compliance (during the year and at year-end) with compliance requirements that could have a direct and material effect on the determination of financial statement amounts.

- Whether changes in equity accounts are properly reported in the financial statements or the notes.

- Whether reconciling items between the fund and the government-wide financial statements are properly calculated and the reconciliations are properly presented.

- Whether financial statement disclosures for equity are in conformity with GAAP.

- If GASBS No. 54 has not been implemented, the following matters:
  - •• Whether equity restrictions, reserves, and designations have been made in compliance with applicable legal and contractual requirements and management policies.
  - •• Whether restricted, reserved, or designated resources are used (a) for their restricted, reserved, or designated purpose and (b) in accordance with management's policy regarding whether to first apply restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.
  - •• Whether equity restrictions, reserves, and designations are removed when no longer required.
  - •• Whether fund balance designations create or increase a negative undesignated fund balance at year-end.
  - •• Whether fund balance designations represent future expenditure intentions instead of unperformed (executory) contracts that should be reported as a reserve for encumbrance.
- If GASBS No. 54 has been implemented, the following matters:
  - •• Whether equity restrictions, commitments, and assignments have been made in compliance with applicable legal and contractual requirements and management policies.
  - •• Whether restricted resources are used for their intended purpose and in accordance with management's policy regarding whether to first apply restricted or unrestricted resources when an expenditure or expense is incurred for purposes for which both restricted and unrestricted fund balance or net assets are available.
  - •• Whether committed or assigned amounts are used for their intended purpose and in accordance with management's policy regarding whether committed, assigned, or unassigned amounts are considered to have been spent when an expenditure is incurred for which amounts in any of those unrestricted fund balance classifications could be used.
  - •• Whether equity restrictions, commitments, and assignments are removed when no longer required.
  - •• Whether overspending of restricted, committed, or assigned resources creates or increases a negative unassigned fund balance at year end.
  - •• Whether encumbrances are included within the applicable fund balance classification and not displayed separately.

The audit of fund equity and financial statement reconciliation concentrates primarily on the financial statement assertions of existence (especially the authorization aspect of existence), accuracy/classification, and disclosures. Assertions consider both legal and accounting requirements. Examples of substantive procedures for equity and financial statement reconciliation:

- Read minutes, debt agreements, or other relevant documents to identify, as applicable, authorizations for reservations, commitments, or assignments of fund balances.
- Determine whether the amount of net assets restricted by enabling legislation has been disclosed in accordance with GAAP.
- Obtain an analysis of changes in equity accounts in aggregate and by component. Compare the balances with those of the prior periods, considering known changes in client operations.
- Obtain and check a schedule of net assets for the government-wide statements and reconciliations from the fund statements to the government-wide statements.

Audit Program for Equity and Financial Statement Reconciliation. A core audit program presents basic substantive audit procedures for equity and financial statement reconciliation. Using the core audit program, the auditor chooses the procedures that will be adequate to obtain sufficient audit evidence for the relevant assertions. A specified risk program presents the substantive audit procedures for equity and financial statement reconciliation that are normally adequate to respond to a set of underlying risk assessments considered typical of many governments.

Auditing Considerations. The auditor needs to evaluate the propriety of any reservations or restrictions that exist as well as consider the need for any such reservations or restrictions that have not been established. The auditor should review all items (e.g., purchase orders, requisitions, and open orders) for which a reservation for encumbrances has been established. Also, the auditor needs to determine that designations have been approved by senior management or the governing body of the governmental unit.

Accounting Considerations—Governmental Fund Financial Statements. For governmental fund equities, the audit and accounting considerations are closely related. The classifications of fund balances depend on whether the government has adopted GASBS No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which is effective for periods beginning after June 15, 2010, with earlier implementation permitted.

If GASBS No. 54 has not been adopted, fund equities may be classified in the following categories:

- *Reserved.* There are two reasons for making reservations of fund balance. In either case, the reserved portion is intended to communicate the portion of fund equity that is not available to pay for new commitments. The two types of reservations are as follows:

  a. *Encumbrances.* A reserve for encumbrances is used when goods or services have been ordered or contracted for but have not been received and no liability yet exists. Once the goods or services are received or consumed, a liability (and expenditure) is recognized and the reserve for encumbrances is eliminated.

  b. *Unexpendable Assets.* This reserve relates to assets that, due to their nonmonetary nature or lack of liquidity, will not be available for current appropriation; e.g., inventories of supplies, prepaid expenses, and long-term receivables.

- *Unreserved.* The unreserved portion of the fund balance may be divided into two categories:

  a. *Designated.* A designation of fund balance is made when the administration adopts tentative plans that, if carried out, would restrict the use of financial resources; e.g., proposed capital projects.

  b. *Undesignated.* This is simply the amount of fund equity remaining after deducting reservations and designations of fund balance.

If GASBS No. 54 has been adopted, fund equities may be classified in the following five categories:

- *Nonspendable.* Fund balances that cannot be spent because they are either:

  a. *Not in Spendable Form.* Generally, amounts that are not expected to be converted to cash, such as inventories or prepaid amounts. This classification also includes some long-term amounts such as property acquired for resale or the long-term portion of loans receivable. (However, if the eventual proceeds or collections from these would be restricted, committed, or assigned, these amounts would be included in that other classification.)

  b. *Legally or Contractually Required to be Maintained Intact.* Amounts that are required to be maintained intact, such as the principal of a permanent fund.

- Restricted. Amounts that can be used only for specific purposes because of (a) constitutional provisions or enabling legislation or (b) externally imposed constraints. (External constraints might be imposed by creditors, grantors, contributors, or even the laws or regulations of other governments.)

- *Committed.* Amounts that can be used only for specific purposes because of a formal action by the government's highest level of decision-making authority. This classification might also include contractual obligations if existing resources have been committed for use in satisfying those contractual requirements. (The formal action to establish constraints should before year-end, even if the amount might not be determined until the subsequent period.)

- *Assigned.* Amounts intended to be used for specific purposes but that do not meet the criteria to be classified as restricted or committed. Intent can be stipulated by the governing body, another body (such as a finance committee), or by an official to whom that authority has been given. This is the residual fund balance classification for all governmental funds except the general fund. Assigned fund balances should not be reported in the general fund if doing so causes the government to report a negative unassigned general fund balance.

- *Unassigned.* This is the residual classification for the general fund—that is, everything that is not in another classification or in another fund. The general fund is the only governmental fund that can report a positive unassigned fund balance. Other governmental funds might have a negative unassigned fund balance as a result of overspending for specific purposes for which amounts had been restricted, committed, or assigned.

Accounting Considerations—Proprietary Funds and Government-wide Financial Statements. Fund equities of proprietary funds and the government-wide financial statements should be displayed in the following components:

- Invested in capital assets net of related debt.

- Restricted (distinguishing between major categories of restrictions).

- Unrestricted.

The fund equities of the governmental funds must be converted to the above components for display in the governmental activities column of the government-wide financial statements.

GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation*, requires governments to provide footnote disclosure of the amount of net assets restricted by enabling legislation as of the end of the reporting period. Enabling legislation is that which both authorizes new resources and imposes legally enforceable limits on how they may be used. GASB Statement No. 46 clarifies that legislation is considered to be legally enforceable if an external party can compel the government to use the resources only for the purposes specified in the enabling legislation.

SELF-STUDY QUIZ

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

47. Lu Newby, staff auditor, is reviewing the fund equities as recorded in the financial statements for Clay Township. During the review, it is determined that the components of the fund equities, while determined to exist and be properly computed and authorized, they have not been reported in accordance with state regulations. Potentially, what audit assertion is violated under this set of circumstances?

    a. Existence or occurrence.

    b. Completeness.

    c. Rights or obligations.

    d. Valuation or allocation.

48. Which of the following substantive audit procedures is **not** relevant to the audit of fund equities?

    a. Read minutes, debt agreements, or other documents to identify authorizations for reservations of fund balances.

    b. Compare balances of debt and related interest expense accounts with those of prior years and investigate any unexpected results.

    c. Consider the need for reservations of fund balances for items such as inventories and long-term assets.

    d. Determine whether the amount of net assets restricted by enabling legislation has been disclosed in accordance with GAAP.

49. Lu Newby, staff auditor, is thinking about the audit considerations for fund equities. In particular, Lu is attempting to discern how to evaluate the propriety of any fund restrictions. How might Lu evaluate fund restrictions?

    a. Lu should review all purchase orders, requisitions and open orders for which a restriction has been established.

    b. Lu should determine if debt has been incurred but not authorized.

    c. Lu should determine if proceeds obtained through issuing debt have been misappropriated.

50. The audit of fund equities includes some unusual terminology. Properly match the definition with the term.

Term	Definition
A. Reserved	i. The portion of a fund balance that is used when goods have been ordered but have not been received.
B. Encumbrances	ii. This reserve relates to assets that, due to their nonmonetary nature, will not be available for current appropriation.
C. Unexpendable	iii. The portion of a fund balance that is intended to communicate the portion of fund equity that is not available to pay for new commitments.

a. A with ii, B with iii, and C with i.

b. A with iii, B with i, and C with ii.

c. A with i, B with iii, and C with ii.

d. A with ii, B with iii, and there is no proper definition for C.

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.)**

47. Lu Newby, staff auditor, is reviewing the fund equities as recorded in the financial statements for Clay Township. During the review, it is determined that the components of the fund equities, while determined to exist and be properly computed and authorized, they have not been reported in accordance with state regulations. Potentially, what audit assertion is violated under this set of circumstances? **(Page 372)**

    a. Existence or occurrence. [This answer is incorrect. The fund equities are based on actual transactions.]

    b. Completeness. [This answer is incorrect. The question scenario includes information indicating the fund equities were properly authorized.]

    c. Rights or obligations. [This answer is correct. The question scenario indicates that Clay Township has not properly complied with state regulations with regard to the fund equities.]

    d. Valuation or allocation. [This answer is incorrect. The fund equities are at the proper amounts.]

48. Which of the following substantive audit procedures is **not** relevant to the audit of fund equities? **(Page 374)**

    a. Read minutes, debt agreements, or other documents to identify authorizations for reservations of fund balances. [This answer is incorrect. This answer choice indicates a valid substantive audit procedure for the audit of fund equities.]

    b. Compare balances of debt and related interest expense accounts with those of prior years and investigate any unexpected results. [This answer is correct. This answer choice would be relevant to the audit of debt.]

    c. Consider the need for reservations of fund balances for items such as inventories and long-term assets. [This answer is incorrect. This answer choice indicates a valid substantive audit procedure for the audit of fund equities.]

    d. Determine whether the amount of net assets restricted by enabling legislation has been disclosed in accordance with GAAP. [This answer is incorrect. This answer choice indicates a valid substantive audit procedure for the audit of fund equities.]

49. Lu Newby, staff auditor, is thinking about the audit considerations for fund equities. In particular, Lu is attempting to discern how to evaluate the propriety of any fund restrictions. How might Lu evaluate fund restrictions? **(Page 374)**

    a. Lu should review all purchase orders, requisitions and open orders for which a restriction has been established. [This answer is correct. This answer choice properly describes an audit program step relevant to fund equities.]

    b. Lu should determine if debt has been incurred but not authorized. [This answer is incorrect. This answer choice describes an audit program step more closely related to the audit of debt.]

    c. Lu should determine if proceeds obtained through issuing debt have been misappropriated. [This answer is incorrect. This answer choice describes an audit program step more closely related to the audit of debt.]

50. The audit of fund equities includes some unusual terminology. Properly match the definition with the term. **(Page 374)**

Term	Definition
A. Reserved	i. The portion of a fund balance that is used when goods have been ordered but have not been received.
B. Encumbrances	ii. This reserve relates to assets that, due to their nonmonetary nature, will not be available for current appropriation.
C. Unexpendable	iii. The portion of a fund balance that is intended to communicate the portion of fund equity that is not available to pay for new commitments.

a. A with ii, B with iii, and C with i. [This answer is incorrect. None of the terms are properly matched with their definition.]

b. A with iii, B with i, and C with ii. [This answer is correct. All three terms are properly matched with their definition.]

c. A with i, B with iii, and C with ii. [This answer is incorrect. Only one term is properly matched with its definition.]

d. A with ii, B with iii, and there is no proper definition for C. [This answer is incorrect. All terms listed have corresponding definition.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (ALGTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

11. Listed below are several local government account types which will be audited. For which account type is the audit approach for a local government audit very similar to that used for business enterprises?

    a. Revenue and expenditures.

    b. Cash and investments.

    c. Operating assets.

    d. Debt and equity.

12. Albert Euclid, audit manager, is discussing relevant assertions with staff auditor Lu Newby. Albert is quizzing Lu regarding the potential application of relevant assertions to the elements of the audit of a local government. Albert gives Lu the following choices:

    i. account balance.

    ii. class of transaction.

    iii. disclosure.

    iv. management representations.

    Albert asks Lu the following question: From the four items listed, which one(s) are included in the auditor's relevant assertions?

    a. iv only.

    b. iv, iii and ii.

    c. iii and ii only.

    d. iii, ii and i.

13. Lu Newby, staff auditor, is looking at all the bank account reconciliations for the City of Marine Creek. Lu notices that out of all the bank accounts owned by the city, only two have major activity. If you were the audit manager for the engagement, how would you recommend Lu handle the confirmation of account balances and why?

    a. Confirm all bank accounts to obtain audit evidence of the existence assertion and rights/obligations assertion.

    b. Confirm only the primary bank accounts to obtain audit evidence of the existence assertion and compare the bank reconciliation of the accounts not confirmed to the bank statement to maintain audit efficiency.

    c. Confirm all bank account balances as required by GAAS, *Government Auditing Standards* and OMB circular A-133.

    d. Confirm no bank account balances; instead maintain audit efficiency by reviewing all bank reconciliations.

14. Lu Newby, staff auditor, has been instructed to start the cash audit for the City of Marine Creek. Listed below are some audit steps which may or may not be relevant to the audit procedures for cash. List in order the steps for starting the cash program.

    i. Confirm bank account balances.

    ii. Confirm compensating balances, lines of credit and written guarantees.

    iii. Identify all depositories.

    iv. Identify funds required by law to be maintained separately.

    v. Test the fair value measurements.

    vi. Identify the source of revenues.

    a. iii, iv, i, and ii.

    b. iv, v, vi, and i.

    c. ii, iii, iv and v.

    d. vi, v, iv, and iii.

15. Which of the following identifies one unusual feature of government engagements related to the audit of bank accounts owned by the governmental unit?

    a. The methods and significant assumptions used to estimate the fair value and if that fair value is based on other than quoted market price.

    b. The policy for reporting cash at amortized cost.

    c. When deposits exceed depository insurance, statues often require the depository institution to pledge securities as collateral for the deposit of the governmental unit.

    d. The significant assumptions used in estimating fair value.

16. Select the answer choice below that best defines the reason why the auditor uses relevant assertions when assessing the risks of material misstatement.

    a. Relevant assertions are used to determine the nature, timing, and extent of the substantive procedures necessary to obtain sufficient appropriate audit evidence.

    b. The auditor suspends the concept of materiality, applies relevant assertions to the chart of accounts and determines which accounts to examine using generally accepted auditing standards.

    c. Without considering what could go wrong in the financial statements, the auditor designs audit procedures that are responsive to the assessed risks.

    d. Relevant assertions are used to determine those audit procedures necessary to meet the firm's economic requirements for the audit.

17. Listed below are some audit procedures at the account balance level for investments. The procedures listed are either analytical or substantive. Properly match the procedure as either analytical or substantive.

Audit Procedure	Type of Procedure
i. Scan the activity during the year in the investment accounts.	1. Analytical procedure.
ii. Compare the balances of the investment accounts to those of the prior year and investigate unusual items.	2. Substantive procedure.
iii. Determine if an investment policy has been adopted by the governmental unit.	
iv. Determine if the governmental unit uses derivatives and management's controls over derivatives.	

a. 1 with iii and iv; 2 with i and ii.

b. 1 with i, ii, iii and iv; 2 with no choice.

c. 1 with i and ii; 2 with iii and iv.

d. 1 with no choice; 2 with i, ii, iii and iv.

18. When considering the audit procedures that should be included in the audit program for investments, the auditor is **not** required to:

a. Concern himself with the size of the investments.

b. Gain an understanding of the governmental unit's policies for investments.

c. Check to make sure the governmental unit uses pooled investments.

d. Worry about the frequency and amount of investment transactions.

19. Lu Newby, staff auditor, is reading an audit step with regard to auditing the investments of a governmental entity. The audit step is to watch for unusual matters. This audit step is attempting to uncover which of the following situations?

a. Whether or not the investments are authorized by law.

b. Whether or not the investments are pooled.

c. An indication of churning.

d. An indication that the investments conform to the investment policy.

20. Lu Newby, staff auditor, wakes up in a cold sweat in a hotel room in Marine Creek after a nightmare about an interview with the media concerning some investment transactions made by the City of Marine Creek which had unfortunate results. What type of investment would most likely lead to unfortunate investment results?

    a. Marketable equity securities.

    b. Marketable debt securities.

    c. Certificate of deposit at a local bank.

    d. Reverse repurchase agreements.

21. Which of the following is the basic standard for valuation of governmental entity investments?

    a. GASBS No. 3.

    b. GASBS No. 25.

    c. GASBS No. 28.

    d. GASBS No. 31.

22. GASBS No. 31, paragraph 5 exempts all of the following assets from fair value reporting **except**:

    a. Investments in equity securities reported using the equity method.

    b. Non-negotiable certificates of deposit.

    c. Investments in joint ventures.

    d. Contractor performance deposits of debt securities.

23. The table below lists some GASB pronouncements and their respective subject matter. Match the GASB pronouncements with their proper subject matter.

Pronouncement Number	Subject Matter
1. GASBS No. 3	i. Disclosures about investments in the notes to the financial statements.
2. GASBS No. 28	ii. Disclosures about investments related to authorization for those investments by legal or contractual provisions and any violation of those provisions during the year and the related risks (i.e. custodial, concentration, interest rate and foreign currency).
3. GASBS No. 31	iii. Disclosures related to securities lending transactions.

    a. 1 with iii, 2 with iv, 3 with i.

    b. 1 with iv, 2 with i, 3 with ii.

    c. 1 with ii, 2 with iii, 3 with i.

    d. 1 with i, 2 with ii, 3 with iii.

24. Listed below are some assertions pertaining to revenues and receivables. Which assertion pertains directly to the rights or obligation assertion for revenues and receivables?

    a. Revenues and receivables pertain to the entity and funds and are properly classified in the financial statements.

    b. Receivables and revenues are recorded in the proper accounting period.

    c. Revenues reported in the financial statements are reported in the proper amount.

    d. The conditions and agreements that affect the governmental unit's receivables have been properly reflected in the financial statements at the end of the period.

25. Listed below are some substantive audit procedures which may or may not apply to the audit of receivables of a government unit. Select those substantive procedures which should be included in an audit of receivables.

    i. Compare the balance in receivables with the balance for prior years and investigate unusual variations.

    ii. Compute the ratio of receivables balance to related revenue for the current and prior years and investigate any unexpected results.

    iii. Confirm selected accounts.

    iv. Inquire of responsible officials about how the government raises revenue and identify the major revenue sources.

    v. Compare amounts to those of prior periods and to the adopted budget. Investigate unexpected results.

    vi. Consider the allocation of revenues to the government's funds in accordance with the intent of the governing body.

    a. iv only.

    b. iv, v and vi.

    c. i only.

    d. i, ii and iii.

26. Listed below are some substantive audit procedures which may or may not apply to the audit of revenue of a government unit. Select those substantive procedures which should be included in an audit of revenue.

    i. Compare the balance in receivables with the balance for prior years and investigate unusual variations.

    ii. Compute the ratio of receivables balance to related revenue for the current and prior years and investigate any unexpected results.

    iii. Confirm selected accounts.

    iv. Inquire of responsible officials about how the government raises revenue and identify the major revenue sources.

    v. Compare amounts to those of prior periods and to the adopted budget. Investigate unexpected results.

    vi. Consider the allocation of revenues to the government's funds in accordance with the intent of the governing body.

    a. iv only.

    b. iv, v and vi.

    c. i only.

    d. i, ii and iii.

27. When should interfund transfers be reported in governmental funds?

    a. After nonoperating revenues and expenses.

    b. In the nonoperating section, whether the fund is making or receiving transfers.

    c. As other financing uses in the funds making transfers and as other financing sources in the funds receiving transfers.

    d. Do not select this answer choice.

28. Listed below are some required disclosures under GASBS No. 48. Which one applies to a transaction in which the government sells or pledges future revenues to directly collateralize its debt?

    a. Identity of and the general purpose for which the secured debt was issued.

    b. The significant assumptions used to determine the amount of the future revenue.

    c. A comparison of the amount received and the present value of the future revenues.

    d. GASBS No. 48 applies only to sales of future revenue streams, not to pledges of future revenues.

29. Which of the following assertions does **not** apply to the audit of expenditures/expenses?

    a. All operations owned by the governmental unit have been accounted for, whether or not they are still in operation.

    b. Related liabilities have all been identified and properly presented in the financial statements.

    c. Information about liabilities required by GAAP is disclosed fairly and at appropriate amounts.

    d. Expenditures/expenses which resulted in liabilities are authorized in accordance with the budget and other regulations and requirements.

30. The audit of accounts payable is focused primarily on which of the following assertions?

    a. Completeness and cutoff.

    b. Existence and valuation.

    c. Existence, rights, and valuation.

    d. Completeness, cutoff, and disclosure assertions.

31. Lu Newby, staff auditor, is attempting to determine what questions to ask about the procurement system for the City of Mount Gay. Using the answer choices below, help Lu determine what questions to ask.

    i. Is the purchasing function centralized or decentralized?

    ii. Who are the primary suppliers?

    iii. What billing practices do the vendors use?

    iv. Are detailed asset ledgers maintained and periodically reconciled to control accounts?

    a. ii and iii.

    b. i and iv.

    c. i, ii and iii.

    d. i, ii, iii and iv.

32. Alfred Euclid, audit manager, is thinking about the fraud angles that may cause a potential misstatement of the amount of payroll expense. Alfred decides that a potential risk would be an employee who is paid and yet is not a valid employee. Which of the following assertions would be relevant to Alfred's current thought process?

    a. Classification.

    b. Existence.

    c. Cutoff.

    d. Allocation.

33. Lu Newby, staff auditor, is performing substantive procedures for the audit of payroll. Lu discovers a significant variance. Which of the following substantive procedures would reveal a significant payroll variance?

    a. Scan bank reconciliations for reasonableness.

    b. Compare pension expense per number of covered employees to the same ratio for the prior period.

    c. Inquire about pledged investments.

    d. Compute the ratio of the receivables balance to related revenue for the current and prior years.

34. Alfred Euclid, audit manager for the audit of the City of Notrees, wants to make sure the audit program adequately verifies the expenditure for payroll. Which of the following answer choices is a reason why payroll padding in a government audit is a low risk?

    a. Civil service systems control abuses of government employment through procedures for adding individuals to the government payroll.

    b. Once the auditor understands the sources of anticipated revenues, he will consider the receipt of actual revenues.

    c. The fair value measurement and disclosure in financial statements is an important element in the audit of payroll.

    d. The starting point for the payroll audit is to identify all depositories and review bank reconciliations.

35. Listed below are some audit assertions pertaining to inventories. Which assertion pertains directly to the rights or obligation assertion for inventories?

    a. Inventories are recorded in the proper accounting period.

    b. Inventories are properly classified in the financial statements.

    c. Inventory listings are properly priced, extended, footed, and summarized with the totals properly recorded by fund type.

    d. The governmental unit has legal title to the inventories reported in the financial statements.

36. Listed below are some substantive audit procedures which may or may not apply to the audit of inventories of a government unit. Select those substantive procedures which should be included in an audit of inventories.

    i. Compare the balance in receivables with the balance for prior years and investigate unusual variations.

    ii. Compute the ratio of receivables balance to related revenue for the current and prior years and investigate any unexpected results.

    iii. Confirm selected accounts.

    iv. Consider the need to count inventory items and compare to the client's counts.

    v. Inquire about the individual funds that have recorded inventory and the accounting method used to record inventory.

    vi. Determine whether inventory amounts reported in the financial statements are properly classified.

    a. iv only.

    b. iv, v and vi.

    c. i only.

    d. i, ii and iii.

37. Lu Newby, staff auditor, is attempting to achieve audit efficiency by using analytical procedures to audit the inventories of the City of Hasseldom. The analytical procedures reveal an unreasonable current inventory balance. What is Lu's next step?

    a. Make a note in the workpapers to include the inventory fluctuation in the auditor's report.

    b. Determine if the individuals charged with governance are competent.

    c. Perform additional procedures.

    d. No additional steps are necessary.

38. Properly match the definition of the consumption and purchase methods of accounting for inventory and determine which method is permissible for government-wide financial statements.

Inventory Method	Definition	Used for Government-wide Financials?
i. Consumption	A. Materials and supplies are charged as expenditures when acquired.	YES.
ii. Purchase	B. Acquisition of materials and supplies is recorded initially in inventory accounts and charged as an expenditure when used.	NO.

a. i, A and yes.

b. ii, B and no.

c. i, B and yes.

d. ii, A and neither yes or no.

39. Which of the following assertions pertains to the cutoff assertion for capital expenditures?

a. Depreciation on capital assets has been properly calculated.

b. Capital assets are valued in accordance with GAAP.

c. Costs which should be capitalized are excluded from expenditures for repair and maintenance.

d. Capital expenditures have been recorded in the correct accounting period.

40. Listed below are some substantive analytical procedures Lu Newby, staff auditor, has performed during the audit of the City of Fort Concho. Which of the audit procedures listed below are actually performed during other areas under audit and yet contribute to the audit evidence for capital assets?

a. Inspecting loan documents, lease agreements, debt confirmations and minutes for audit evidence.

b. Compare balances for capital assets with balances for prior years.

c. Make inquiries of the client concerning capital assets and deletions.

d. Scan the capital assets schedule and determine if depreciation methods are reasonable.

41. Lu Newby, staff auditor, is performing the following audit steps. What area of the financial statements of the local government under audit is Lu currently working on?

i. Make inquiries concerning the nature and extent of self-construction.

ii. Determine the nature and extent of leases for buildings and equipment.

iii. Compare expenditures to the capital budget.

a. Cash.

b. Revenue and receivables.

c. Inventories.

d. Capital expenditures.

42. Match the correct fund-level accounting for the following circumstances related to donated assets.

Circumstance	Fund-level Accounting
A. Asset donated to proprietary funds.	i. Report in the governmental fund.
B. Asset donated to governmental funds.	ii. No entry required.
C. Donated capital asset is to be liquidated.	iii. Reported as revenues, capitalized and depreciated.

a. A with iii, B with ii and C with i.

b. A with i, B with ii and C with iii.

c. A with ii, B with iii and C with i.

d. A with ii, B with i and C with ii.

43. What bearing do the relevant assertions have in the auditor's design of an audit? The relevant assertions—

a. Determine exactly which accounts to select when confirming accounts receivable.

b. Can provide an indication that related account balances are fairly stated.

c. Are able to fulfill the obligation on every audit to discover fraud in the financial statements.

d. Calculate the profitability of the audit client.

44. Lu Newby, staff auditor, is performing the following audit steps:

A. Review documentation prepared by the governmental unit supporting compliance with debt covenants, restrictions, etc. and perform the following procedures (if applicable):

1. Confirm restrictions, terms, and proceeds with the lender or underwriter.
2. Confirm compliance with appropriate covenants with the trustee.
3. Document items tested or selected for confirmation. Retain returned confirmations.

What relevant assertions are covered by these audit steps?

i. Existence or occurrence.

ii. Completeness.

iii. Rights or obligations.

iv. Valuation of allocation.

v. Accuracy or classification.

vi. Cutoff.

a. i, ii and iii.

b. ii, iii and iv.

c. iii, iv and v.

d. iv, v and vi.

45. Listed below are some substantive audit procedures. Select the procedure which will help staff auditor, Lu Newby, determine if the debt on the balance sheet of a local government is properly valued.

    a. Compare balances of debt and related interest expense accounts with those of prior years and investigate any unexpected results.

    b. Read minutes, debt agreements or other relevant documents to identify authorizations for reservations of fund balances.

    c. Consider the need for reservations of fund balances for items such as inventories and long-term assets.

    d. Determine whether the amount of net assets restricted by enabling legislation has been properly disclosed.

46. Listed below are some specified risks. Which one pertains to debt and debt service expenditures and would result in the overstatement of debt?

    a. The entity failed to record all transactions under capital leases.

    b. Transactions reflected in the account balances did not actually transpire.

    c. Information about debt is not fairly disclosed.

    d. Fund equities are not determined in accordance with state or local law.

47. Lu Newby, staff auditor, recalls there is a cutoff value in which issuers of municipal securities do not have to comply with SEC Rule 15c2-12. What is the amount Lu is attempting to recall from memory?

    a. $500,000.

    b. $750,000.

    c. $850,000.

    d. $1,000,000.

48. Which of the following answer choices properly reflects the relevant audit assertion for valuation of fund equities?

    a. Fund equities reflected in the financial statements are based on actual transactions.

    b. All changes in equity related to the period have been recorded.

    c. Components of fund equities have been properly reflected in the financial statements.

    d. Equity transactions and events have been recorded in the correct accounting period.

49. Lu Newby is conducting the following substantive audit procedure. Consider the need for reservations of fund balances for items such as inventories. What area is Lu auditing?

    a. Payroll.

    b. Debt.

    c. Fund equities.

    d. Cash.

50. Which of the following is **not** the proper component for displaying fund equities of proprietary funds in a government-wide financial statement?

    a. Invested in capital assets net of related debt.

    b. Encumbered.

    c. Restricted.

    d. Unrestricted.

GLOSSARY

Accuracy: Amounts and other data relating to the recorded transactions and events have been recorded appropriately. Accuracy and classification is considered by agreeing or reconciling the financial statements to the general ledger.

Analytical Procedure: Analytical procedures include trend analysis, ratio analysis, and predictive or reasonableness tests.

Audit Objective: Generally, it is necessary to specify audit objectives and select appropriate procedures to achieve those objectives for each major class of revenue and expense transaction.

Audit Strategy: 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. 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).

Churning: Making unnecessary investment trades to generate fee income for the investment manager.

Classification: Transactions and events have been recorded in the appropriate accounts.

Completeness: All transactions and events that should have been recorded have been recorded. All assets, liabilities, and equity interests that should have been recorded have been recorded.

Consumption Method: Consumption method means that acquisition of materials and supplies is recorded initially in inventory accounts and charged as expenditure when used. Reservation of the fund balance is not required for the consumption method unless a minimum amount of inventory has been identified as necessary.

Cutoff: Transactions and events have been recorded in the correct accounting period.

Donated Capital Asset: The fund-level accounting for donated capital assets depends on whether the fund is a proprietary fund or a governmental fund. For proprietary funds, donated capital assets are reported as revenues, capitalized, and depreciated. For governmental funds, when a government receives a donated asset that it intends to use as a general capital asset, no entry is required because no financial resource flow has taken place. However, if the government intends to liquidate the donated capital asset, the asset would be reported in a governmental fund. The authors recommend that the auditor obtain evidence that the government's intent is supported by a contract for sale prior to issuance of the financial statements. Otherwise, the donated asset should be treated like a capital asset that is used in operations until a sale occurs.

Existence or Occurrence: Assets, liabilities, and equity interests exist. Transactions and events that have been recorded have occurred and pertain to the entity.

GASBS No. 3: GASBS No. 3, as amended by GASBS No. 40, *Deposit and Investment Risk Disclosures*, requires certain disclosures related to cash deposits with financial institutions, including the types of deposits authorized by legal and contractual provisions; any violations of those provisions during the period; and the portion of bank balances for which there is collateral credit risk at year end.

GASBS No. 25: GASBS NO. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, specifies accounting and financial reporting requirements for governmental pension plans and is documented in the GASB Codification at Pe5. Pe5.116 requires that all plan investments, including debt and equity securities, real estate, and other investments except insurance contracts, be reported at their fair value at the reporting date.

GASBS No: 28: GASBS NO. 28 requires certain disclosures related to securities lending transactions, including the source of legal authorization for participation, a description of the transactions, and several risk disclosures.

GASBS No. 31: GASBS NO. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools* (GASB Cod. sec. I50), is the basic standard for valuation of governmental entity investments. The requirements of GASBS No. 31 provide consistency in reporting among governments and additional information to users of financial statements by establishing fair value standards for certain investments held by governmental entities and external investment pools.

GASBS No. 34: GASBS NO. 34 requires governments to report all expenses in their government-wide financial statements by function except for those that meet the definitions of special items or extraordinary items. (Transfers, which are neither revenues nor expenses, should also be excluded from program expenses.) At a minimum, governments should report direct expenses for each function.

GASBS No. 48: GASBS No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, issued in September 2006, provides guidance to governments that sell or pledge either receivables or future revenues. GASBS No. 48 also provides guidance when those transactions take place between the primary government and a separate legal entity that is required by GASBS No. 14 to be reported as a blended or discretely presented component unit. However, the scope of GASBS No. 48 excludes the relatively common situation in which governments pledge their "full faith and credit" as security for their own debt, such as for general obligation bonds or revenue bonds, or for the debt of a component unit.

General Planning Procedures: Include engagement acceptance procedures, the procedures for obtaining an understanding of the entity and its environment, internal control, assessing the risk of material misstatement, determining planning materiality, etc

Occurrence: Transactions and events that have been recorded have occurred and pertain to the entity.

Pledged Securities: An unusual feature of governmental engagements is the need to be concerned with collateral pledged to secure deposits. State statutes often require that cash deposits be collateralized by the depository institution. When deposits exceed depository insurance, statutes often require the depository to pledge specified types of securities as collateral; e.g., some states require collateral pledges equal to 100% to 125% of the uninsured deposits.

Purchase Method: Purchase method means that materials and supplies are charged as expenditures when acquired, and inventory on hand at the end of the period is recorded as an asset (debit), and a reservation of the fund balance is required. Reservation of the fund balance is required for the purchase method, but not required for the consumption method unless a minimum amount of inventory has been identified as necessary.

Relevant Assertions: Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. For example, valuation may not be relevant to cash accounts unless currency translation is involved

Reverse Repurchase Agreements: In a basic reverse repurchase agreement, the governmental unit acts as a "seller-borrower" and transfers federal obligations for cash and promises to repay the cash plus interest in return for the same securities. In a reverse repurchase agreement, the governmental unit reports the "obligation under reverse repurchase agreements" as a government fund liability, regardless of the maturity date of the agreement, and the underlying securities are reported as investments.

Rights or Obligations: The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

Risk Assessment Summary Form: Documents the assessed risks by assertion and the audit approach to respond to the assessed risks.

Risks of Material Misstatment: Generally, areas or assertions with a higher assessed risk of material misstatement require more assurance from substantive procedures. This is generally accomplished by supplementing the basic procedures with one or more extended procedures.

SEC Rule 15c2-12: SEC Rule 15c2-12 requires issuers of municipal securities in aggregate principal amounts of $1 million or more to report financial and operational information and notices of material events to nationally recognized municipal securities information repositories (NRMSIRs) and to a state information depository (SID), if one exists.

SLG: AICPA Audit and Accounting Guide, *State and Local Governments*.

Source of Revenue: Governmental units receive revenue from a variety of sources, including various taxes, licenses, fees, permits, grants, and contracts. The auditor needs to determine the governmental unit's various revenue sources by, among other things, reading legal documents such as budgets, enabling legislation, and grant agreements, inquiring of responsible officials concerning sources of revenue, and reviewing the prior period's financial statements.

Specific Audit Programs: Specific audit programs have a mixed approach that emphasizes the cycle approach for revenues and some expenditures but emphasizes balance sheet categories for other audit areas.

Specified Risk Programs: Identify procedures that are basic to most small government audit engagements. This set of programs is designed to increase audit efficiency by linking the financial statement assertions, risk assumptions, and procedures.

Substantive Procedure: Substantive procedures consist of (a) tests of details of classes of transactions, account balances, and disclosures, and (b) substantive analytical procedures.

Valuation or Allocation: Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Local Governments—Course 1—Substantive Procedures and Testing Internal Controls (ALGTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 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 $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

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2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
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Course Acronym: ALGTG101

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

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Local Governments—Course 2—Risk Assessment Procedures and Planning (ALGTG102)

Price $79

First Name: ______________________

Last Name: ______________________

Firm Name: ______________________

Firm Address: ______________________

City: ______________________ State /ZIP: ______________

Firm Phone: ______________________

Firm Fax No.: ______________________

Firm Email: ______________________

Express Grading Requested: ☐ Add $24.95

Signature: ______________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⦸ ⊗ ✓ .

	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 by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: March 31, 2011

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—Risk Assessment Procedures and Planning

Course Acronym: ALGTG102

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. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC'S GUIDE TO AUDITS OF LOCAL GOVERNMENTS—Course 3—Audit Programs (ALGTG103)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** 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 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   ALGTG103 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

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

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 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 $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **March 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

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

EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Local Governments—Course 3—Audit Programs (ALGTG103)

Price $79

First Name: ______________________

Last Name: ______________________

Firm Name: ______________________

Firm Address: ______________________

City: ______________________ State /ZIP: ______________________

Firm Phone: ______________________

Firm Fax No.: ______________________

Firm Email: ______________________

Express Grading Requested: ☐ Add $24.95

Signature: ______________________

Credit Card Number: ______________________ Expiration Date: ______________________

Birth Month: ______________________ Licensing State: ______________________

Answers:

Please Indicate Your Answer By Filling In The Appropriate Circle As Shown: Fill In Like This ● Not Like This ⃠ ⊗ ✓ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	14.	○	○	○	○	27.	○	○	○	○	39.	○	○	○	○
2.	○	○	○	○	15.	○	○	○	○	28.	○	○	○	○	40.	○	○	○	○
3.	○	○	○	○	16.	○	○	○	○	29.	○	○	○	○	41.	○	○	○	○
4.	○	○	○	○	17.	○	○	○	○	30.	○	○	○	○	42.	○	○	○	○
5.	○	○	○	○	18.	○	○	○	○	31.	○	○	○	○	43.	○	○	○	○
6.	○	○	○	○	19.	○	○	○	○	32.	○	○	○	○	44.	○	○	○	○
7.	○	○	○	○	20.	○	○	○	○	33.	○	○	○	○	45.	○	○	○	○
8.	○	○	○	○	21.	○	○	○	○	34.	○	○	○	○	46.	○	○	○	○
9.	○	○	○	○	22.	○	○	○	○	35.	○	○	○	○	47.	○	○	○	○
10.	○	○	○	○	23.	○	○	○	○	36.	○	○	○	○	48.	○	○	○	○
11.	○	○	○	○	24.	○	○	○	○	37.	○	○	○	○	49.	○	○	○	○
12.	○	○	○	○	25.	○	○	○	○	38.	○	○	○	○	50.	○	○	○	○
13.	○	○	○	○	26.	○	○	○	○										

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Expiration Date: March 31, 2011

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—Audit Programs

Course Acronym: ALGTG103

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. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please Provide Any Constructive Criticism You May Have About The Course Materials, Such As Particularly Difficult Parts, Hard To Understand Areas, Unclear Instructions, Appropriateness Of Subjects, Educational Value, And Ways To Make It More Fun. Please Be As Specific As You Can.
(Please Print Legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For More Information On Our Cpe & Training Solutions, Visit Trainingcpe.thomson.com. Comments May Be Quoted Or Paraphrased For Marketing Purposes, Including First Initial, Last Name, And City/State, If Provided. If You Prefer We Do Not Publish Your Name, Write In "no" And Initial Here ________